

**Goizueta Business School
Emory University**

Bus 725 Behavioral Finance (Advanced Topics in Finance–II)
Monday 2:30-3:45, Room W520

Fall 2008

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Overview of the Course

Behavioral finance is often presented as a challenge to rational decision making and market efficiency. Borrowing from the literature on market efficiency, we can group departures from rational behavior into three familiar categories (weak, semi-strong, and strong). In the weak-form, psychological biases affect investing behavior and can influence welfare but have no lasting impact on asset prices. In the semi-strong form, behavioral biases also have an effect on corporate managers but any suboptimal behavior is recognized by the market and incorporated into security prices. Finally, in the strong form behavioral biases are so pervasive that they can lead asset prices to depart nontrivially from fundamental values.

This half-semester course is designed to provide students with exposure to behavioral finance. We'll begin with an overview of behavioral biases documented in the cognitive psychology literature and then discuss their implications for finance.

Readings

Many of the books on behavioral finance are collections of journal articles. We'll focus on the articles themselves, with references to some of the helpful literature surveys.

Grading

Each student is expected to make six 20 minute presentations. Grading is based on the presentations and class participation.

Office Hours

You can stop by any time. If you want to make sure that I'm free, send me an email first.

The Daily Schedule

The schedule below is intended as a guide. It may be modified depending on the speed and comfort level of the class.

Session	Date	Topic	Presentations
1	9/8	Overview of Behavioral Biases	
2	9/15	Overview of Behavioral Biases (continued)	
3	9/22	Investor Behavior – Portfolio Construction and Home Bias	(1, 2)
4	9/29	Investor Behavior – Trading	(3, 4)
5	10/6	Investor Behavior – Attention and Weather	(5, 6)
	10/13	Fall Break	
6	10/20	Corporate Finance – Manager Behavior	(7, 8)
7	10/27	Limits to Arbitrage – Theory	(9, 10)
8	11/3	Limits to Arbitrage – Empirical	(11, 12)
9	11/10	Behavioral Models – Prospect Theory	(13, 14)
10	11/17	Behavioral Models – Overconfidence	(15, 16)
11	11/24	Tests of Behavioral Models – Prospect Theory	(17, 18)
12	12/1	Tests of Behavioral Models – Sentiment, Comovement	(19, 20)
13	12/8	Tests of Behavioral Models – Misreaction	(21, 22)
14	12/15	Tests of Behavioral Models – Attention, Lotteries	(23, 24)

Readings

Overview

Surveys

- Baker, Malcolm, Richard Ruback, and Jeffrey Wurgler, 2004, “Behavioral Corporate Finance: A Survey,” *Handbook of Empirical Corporate Finance*, forthcoming.
- Barberis, Nicholas, and Richard Thaler, 2003, “A survey of behavioral finance,” in *Handbook of the Economics of Finance*, G. Constantinides, M. Harris, and R. Stulz (ed.), North-Holland, Amsterdam.
- Daniel, Kent D. and Kent L. Womack, 2001, “Behavioral finance” book chapter published in *Handbook of Modern Finance*, edited by Dennis E. Logue and James K. Seward, Warren Gorham & Lamong, Section B1, 1-30.
- Hirshleifer, David, 2001, “Investor psychology and asset pricing,” *Journal of Finance* 56: 1533-1597
- Kahneman, D., 2003, “Maps of bounded rationality: Psychology for behavioral economics,” *American Economic Review* 93, 1449-1475.
- Hirshleifer, David, and Siew Hong Teoh, 2008, “Thought and behavior contagion in capital markets,” Working Paper, UC Irvine.
- Subrahmanyam, Avanidhar, 2007, “Behavioural finance: A review and synthesis,” *European Financial Management* 14: 12-29.

Commentaries

- Debondt, Werner F.M., 1998, Behavioral economics: A portrait of the individual investor, *European Economic Review*, 42: 831-844.
- Fama, Eugene F., 1998, Market efficiency, long-term returns, and behavioral finance, *Journal of Financial Economics* 49, 283-306.
- Kahneman, D., 2003, “A Psychological Perspective on Economics,” *American Economic Review* 93, 162-168.
- Malkiel, Burton G., 2003, “The efficient market hypothesis and its critics,” *Journal of Economic Perspective* 17, 59-82.
- Shiller, Robert J., 2003, “From Efficient Markets Theory to Behavioral Finance,” *Journal of Economic Perspective* 17, 83-104.
- Thaler, Richard H., 2000, “From homo economicus to homo sapiens” *Journal of Economic Perspectives*, 14: 133-141.

Investor Behavior

Portfolio Construction

- ❖ (1) Benartzi, S. and Thaler, R., 2001, “Naive diversification strategies in defined contribution savings plans” *American Economic Review*.
- Benartzi, S. and Thaler, R., 2007, “Heuristics and biases in retirement savings behavior,” *Journal of Economic Perspectives* 21: 81-104.
- ❖ (1) Benartzi, S. and Thaler, R., 2001, “Excessive extrapolation and the allocation of 401(k) accounts to company stock,” *Journal of Finance* 56: 1747-1764.

- Benartzi, S. and Thaler, R., 2002, “How much is investor autonomy worth?” *Journal of Finance*, 57: 1593-1616.
- Polkovnichenko, Valery, 2005, “Household portfolio diversification: A case for rank-dependent preferences,” *Review of Financial Studies*
- Rosen, Harvey S., and Stephen Wu, 2004, “Portfolio choice and health status,” *Journal of Financial Economics*, 72: 457-484.
- Thaler, Richard H., and Shlomo Benartzi, 2004, “Save More Tomorrow: Using behavioral economics to increase employee savings,” *Journal of Political Economy*, 112: S164:S187.

Home Bias

- ❖ (2) Coval, Joshua C. and T. Moskowitz, 1999, “Home bias at home: Local equity preference in domestic portfolios,” *Journal of Finance* 54, 2045-2073.
- Coval, J., and T. Moskowitz (2001), “The geography of investment: informed trading and asset prices,” *Journal of Political Economy* 109, 811-841.
- French, K., and J. Poterba, 1991, “Investor diversification and international equity markets”, *American Economic Review* 81, 222-226.
- ❖ (2) Grinblatt, M., and M. Keloharju (2001), “How distance, language, and culture influence stockholdings and trades,” *Journal of Finance* 56, 1053-1073.
- Huberman, G. (2001), “Familiarity breeds investment,” *Review of Financial Studies* 14, 659-680.
- Hong, Harrison, Jeffrey Kubik, and Jeremy Stein, 2008, “The only game in town: Stock-price consequences of local bias.” *Journal of Financial Economics*, forthcoming.
- Ivkovic, Zoran, and Scott Weisbenner, 2005, “Local does local is: information content of the geography of individual investors’ common stock investments,” *Journal of Finance* 60, 267-306.
- Kang, J. and R. Stulz, 1997, “Why is there a home bias? An analysis of foreign portfolio equity ownership in Japan,” *Journal of Financial Economics* 46, 3-28.
- Massa, Massimo, and Andrei Simonov, 2006, “Hedging, familiarity and portfolio choice,” *Review of Financial Studies* 19: 633-685.

Trading

- Barber, Brad M., and Terrance Odean, 2000, Trading is hazardous to your wealth: The common stock investment performance of individual investors,” *Journal of Finance* 55, 773-806.
- Barber, B., and T. Odean (2001), “Boys will be boys: gender, overconfidence, and common stock investment,” *Quarterly Journal of Economics* 116:261–292.
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- Coval, Joshua D., and Tyler Shumway, 2001, “Is sound just noise?” *Journal of Finance*, 56: 1887-1910.
- ❖ (4) Coval, Joshua D., and Tyler Shumway, 2005, “Do behavioral biases affect prices?” *Journal of Finance*, 60: 1-34.
- Grinblatt, M., and M. Keloharju (2001), “What makes investors trade?” *Journal of Finance* 56, 589-616.

- Heath, Chip, Steven Huddart, and Mark Lang, 1999, “Psychological factors and option exercise,” *Quarterly Journal of Economics*, 114:601-627.
- ❖ (4) Kumar, Alok, 2008, “How do decision frames influence the stock investment choices of individual investors,” *Management Science* 54: 1052-1064.
- Locke, Peter R., and Steven C. Mann, 2005, “Professional trader discipline and trade disposition,” *Journal of Financial Economics*, 76:401-444.
- ❖ (3) Odean, Terrance, 1998, Are investors reluctant to realize their losses? *Journal of Finance*, 53, 1775-1798.
- Odean, Terrance, 1998, “Volume, volatility, price, and profit when all traders are above average,” *Journal of Finance*, 53, 1887-1934.
- ❖ Poteshman, Allen M., and Vitaly Serbin, 2002, “Clearly irrational financial behavior: Evidence from the early exercise of exchange traded stock options,” *Journal of Finance* 58: 37-70.
- ❖ (3) Shefrin, H., and M. Statman (1985), “The disposition to sell winners too early and ride losers too long,” *Journal of Finance* 40, 777–790.
- Statman, Meir, Steven Thorley, and Keith Vorkink, 2006, “Investor overconfidence and trading volume,” *Review of Financial Studies*.

Attention

- ❖ (5) Barber, Brad M., and Terrance Odean, 2008, “All that glitters: The effect of attention and news on the buying behavior of individual and institutional investors,” *Review of Financial Studies*, forthcoming.
- Chen, Joseph, Harrison Hong, Jeremy C. Stein, 2002, “Breadth of ownership and stock returns,” *Journal of Financial Economics*, 66: 171-205.
- DellaVigna, Stefano, and Joshua Pollet, 2008, “Investor inattention, firm reaction, and Friday earnings announcements,” *Journal of Finance*, forthcoming.
- ❖ (5) Gervais, Simon, Ron Kaniel, and Dan H. Mingelgrin, 2001, “The high-volume return premium,” *Journal of Finance*, 56: 877-919.
- Grullon, Gustavo, George Kanatas, and James P. Weston, “Advertising, Breadth of Ownership, and Liquidity,” *Review of Financial Studies*, 17: 439-461.
- ❖ (5) Yuan, Yu, 2008, Attention and trading, Working Paper, Wharton.

Weather

- ❖ (6) Hirshleifer, David and Tyler Shumway, 2003, “Good day sunshine: stock returns and the weather,” *Journal of Finance* 58, 1009-1032.
- Kamstra, Mark, Lisa A. Kramer, and Maurice D. Levi, 2000, “Losing sleep at the market: The daylight saving anomaly,” *American Economic Review*, 94: 1005-1011.
- Kamstra, Mark, Lisa A. Kramer, and Maurice D. Levi, 2003, “Winter Blues: A SAD stock market cycle,” *American Economic Review*, 93: 324-343.
- Saunders, Edward M, Jr. 1993, “Stock prices and weather,” *American Economic Review* 83, 1337-1345.
- ❖ (6) Yuan, Kathy, Lu Zheng, and Qiaoqiao Zhu, 2006, Are Investors Moonstruck? Lunar Phases and Stock Returns, *The Journal of Empirical Finance*, 13 (1): 1-23.

Corporate Finance – Manager Behavior

Manager Response to Investor Biases

- ❖ (7) Baker, Malcolm, and Jeffrey Wurgler, 2004, “A catering theory of dividends,” *Journal of Finance*, 59: 1125-1165.
- ❖ (7) Baker, Malcolm, and Jeffrey Wurgler, 2004, “Appearing and disappearing dividends: The link to catering incentives,” *Journal of Financial Economics*, 73: 271-288.
- DeGeorge, Francois, Jayendu Patel, and Richard Zeckhauser, “Earnings Management to Exceed Thresholds,” *Journal of Business* 72: 1-33.
- ❖ (7) Shefrin, Hersh and Meir Statman, 1984, “Explaining investor preference for cash dividends,” *Journal of Financial Economics* 13, 253-282.
- Baker, Malcom, Robin Greenwood, and Jeffrey Wurgler, 2007, “Catering through nominal share price,” Working Paper Harvard.

Manager Bias

- Blanchard, Olivier Jean, Florencio Lopez-de-Silanes, and Andrei Shleifer, 1994, “What do firms do with cash windfalls?” *Journal of Financial Economics* 36: 337-360.
- Heaton, J.B., 2002, “Managerial Optimism and Corporate Finance,” *Financial Management*, Summer: 33-45.
- ❖ (8) Malmendier, Ulrike, and Geoffrey Tate, 2005, “CEO overconfidence and corporate investment,” *Journal of Finance* 60: 2661-2700.
- ❖ (8) Roll, Richard, 1986, “The hubris hypothesis of corporate takeovers,” *Journal of Business*, 59: 197-216.

Limits of Arbitrage – Theory

- Abreu, Dilip, and Markus K. Brunnermeier, 2002, “Synchronization risk and delayed arbitrage,” *Journal of Financial Economics* 66:341–360.
- ❖ (9) DeLong, Bradford, Andrei Shleifer, Lawrence Summers, and Robert Waldman, 1991, “The survival of noise traders in financial markets,” *Journal of Business* 64, 1-19.
- ❖ (9) DeLong, Bradford, Andrei Shleifer, Lawrence Summers, and Robert Waldman, 1990, “Noise trader risk in financial markets,” *Journal of Political Economy* 98, 703-738.
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- ❖ (10) Shleifer, Andrei, and Robert Vishny, 1997, “The limits of arbitrage,” *Journal of Finance* 52, 35-55.

Limits of Arbitrage – Empirical

- Ali, Ashiq, Lee-Seok Hwang, and Mark A. Trombley, 2003, “Arbitrage risk and the book-to-market anomaly,” *Journal of Financial Economics* 69, 355-373.
- ❖ (11) Baker, Malcolm and Serkan Sava-soglu, 2002, “Limited arbitrage in mergers and acquisitions,” *Journal of Financial Economics* 64, 91-115.
- ❖ (12) Froot, Kenneth A., and Emil M. Dabora, 1999, “How are stock prices affected by the location of trade?” *Journal of Financial Economics* 53: 189-216.

- Greenwood, Robin, 2005, “Short- and long-term demand curves for stocks: Theory and evidence on the dynamics of arbitrage,” *Journal of Financial Economics* 75: 607-649.
- ❖ (12) Lamont, Owen A., and Richard H. Thaler (2004), “Can the market add and subtract? Mispricing in tech stock carve-outs,” *Journal of Political Economy* 111:227–268.
- ❖ (11) Mitchell, M., T. Pulvino and E. Stafford (2002), “Limited arbitrage in equity markets,” *Journal of Finance* 57, 551–584.
- Ofek, Eli and Matthew Richardson, 2002, “DotCom mania: The rise and fall of Internet stocks,” *Journal of Finance* 58, 1113-1138.
- Ofek, Eli, Matthew Richardson, and Robert F. Whitelaw, 2004, “Limited arbitrage and short sales restrictions: Evidence from the options markets,” *Journal of Financial Economics* 74, 305-342.
- Pontiff, Jeffrey, 2006, “Costly arbitrage and the myth of idiosyncratic risk,” *Journal of Accounting and Economics* 42: 35-52.
- Wurgler, Jeffrey, and Ekaterina Zhuravskaya, 2002, “Does arbitrage flatten demand curves for stocks,” *Journal of Business*, 75:583-608.

Behavioral Models

Prospect Theory

- ❖ (13) Barberis, Nicholas, and Ming Huang (2001), “Mental accounting, loss aversion and individual stock returns,” *Journal of Finance* 56, 1247-1292.
- ❖ (13) Barberis, Nicholas, Ming Huang, and Tano Santos, 2001, “Prospect theory and asset prices,” *Quarterly Journal of Economics* 116, 1-53.
- Kahneman, Daniel, and Amos Tversky, 1979, Prospect theory: An analysis of decision under risk, *Econometrica* 47, 263-291.
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- Li, Yan, and Liyan Yang, 2008, “Prospect Theory, the Disposition Effect and Asset Prices, Working Paper, Cornell.
- (14) Barberis, Nicholas, and Wei Xiong, 2008, “What drives the disposition effect? An analysis of a long-standing preference based Explanation,” *Journal of Finance*, forthcoming.

Sentiment

- Baker, Malcolm, and Jeremy Stein, 2004, “Market liquidity as a sentiment indicator,” *Journal of Financial Markets* 7, 271-299.
- Barberis, Nicholas, Angrei Shleifer, and Robert Vishny, 1998, A model of investor sentiment, *Journal of Financial Economics* 49, 307-343.

Overconfidence

- ❖ (15) Daniel, Kent, David Hirshleifer, and A. Subrahmanyam, 2001, “Overconfidence, arbitrage, and equilibrium asset pricing,” *Journal of Finance* 56, 921-965.
- ❖ (15) Daniel, Kent, David Hirshleifer, and A. Subrahmanyam, 1998, “Investor psychology and security market under- and overreactions,” *Journal of Finance* 53, 1839-1985.
- ❖ Gervais, Simon, and Terrence Odean, 2001, “Learning to be overconfident,” *Review of Financial Studies* 14, 1-27.

- ❖ (16) Hong, Harrison and Jeremy C. Stein, 1999, “A unified theory of underreaction, momentum trading and overreaction in asset markets,” *Journal of Finance* 54, 2143-2184.
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Other

- ❖ (16) Barberis, Nicholas, Ming Huang, and Richard H. Thaler, 2006, “Individual preferences, monetary gambles, and stock market participation: A case for narrow framing,” *American Economic Review* 96: 1069-1090.
- Barberis, Nichole and Andrei Shleifer (2003), “Style investing,” *Journal of Financial Economics* 68, 161–199.
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Tests of Behavioral Models

Prospect Theory

- ❖ (17) Grinblatt, Mark, and Bing Han, 2005, “Prospect Theory, Mental Accounting, and Momentum,” *Journal of Financial Economics* 78: 311-339.
- ❖ (17) Ljungqvist, Alexander and William Wilhelm, 2005, “Does prospect theory explain IPO market behavior?” *Journal of Finance* 60: 1759-1790.

Sentiment

- Barberis, Nicholas, Andrei Shleifer, and Jeffrey Wurgler, 2005, “Comovement,” *Journal of Financial Economics* 75: 283-317.
- ❖ (18) Baker, Malcolm, and Jeffrey Wurgler, 2006, “Investor Sentiment and the Cross-Section of Stock Returns,” *Journal of Finance* 61: 1645-1680.
- Bodurtha, James N. Jr., Dong-Soon Kim, and Charles M.C. Lee, 1995, “Closed-end country funds and U.S. Market Sentiment,” *Review of Financial Studies* 8: 879-918.
- Lee, Charles M.C., Andrei Shleifer, and Richard Thaler, 1991, “Investor sentiment and the closed-end fund puzzle,” *Journal of Finance* 46:75-110.
- ❖ (18) Lemmon, Michael, and Evgenia Portniaguina, 2006, “Consumer confidence and asset prices: Some empirical evidence,” *Review of Financial Studies* 19: 1499-1529.

Comovement

- Barberis, Nicholas, Andrei Shleifer, and Jeffrey Wurgler, 2005, “Comovement,” *Journal of Financial Economics* 75: 283-317.
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- ❖ (19) Kumar, Alok and Charles Lee, 2006, “Retail investor sentiment and return comovements,” *Journal of Finance* 61: 2451-2486.
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Misreaction

- ❖ (20) Chan, Wesley S, Richard Frankel, S.P. Kothari, 2004, “Testing behavioral finance theories using trends and consistency in financial performance,” *Journal of Accounting and Economics* 38: 3-50.
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- ❖ (22) Titman, S., K.C.J. Wei, and F.X. Xie, 2004, “Capital investments and stock returns,” *Journal of Financial and Quantitative Analysis* 39: 677-700.

Attention

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Lotteries

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- ❖ (24) Bali, Turan, Nusret Cakici, and Robert Whitelaw, 2008, “Maxing out: Stocks as lotteries and the cross-section of expected returns,” Working Paper, NYU.
- Lobe, Sabastian, and Alexander Holzl, 2008, “Why are British premium bonds so successful? The effect of saving with a thrill,” Working Paper, University of Regensburg.
- Kumar, Alok 2007, “Who gambles in the stock market,” Working Paper, University of Texas.

- Dorn, Daniel, and Gur Huberman, 2008, “Preferred risk habitat of individual investors,” Working Paper, Columbia.
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