FIN 70990 Behavioral Finance  
Fall 2014

PROFESSOR: Andriy Bodnaruk

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Office Hour: TR 15:00 – 17:00 or by appointment
Class Time: TR 13:00 – 14:50  
Classroom: Mendoza 158

COURSE OVERVIEW:

The purpose of this course is to provide an understanding of the behavioral biases and their effects on financial markets. Standard finance theory assumes that market participants are rational expected utility maximizers. Consequently, security prices are expected to be equal to the "fundamental value" at all times and the assumption of no arbitrage led to the notion of market efficiency. Unfortunately, it has become clear that basic facts about the stock market and individual trading behavior cannot be easily explained using this framework. Behavioral finance argues that some financial phenomena can be better understood admitting that some investors are not fully rational and arbitrageurs have limits to how aggressively they could trade.

This course has two building blocks: limits to arbitrage, which argues that it can be difficult for rational traders to undo the dislocations caused by less rational traders; and psychology/investor sentiments, which catalogues the kinds of deviations from full rationality we might expect to see. A number of stock mark anomalies will be presented and analyzed. We will try to explain them with the behavioral biases, but also try to reconcile them within the rational paradigm

COURSE REQUIREMENTS:

(1) There will be one midterm during the semester in addition to the final exam. Examinations will be given on announced days during regular class periods (or other scheduled times). No make-up exams will be given without prior approval from the instructor or a University excused absence. Exams missed without prior approval will result in a score of zero without exception!

(2) There will be one (1) case study and one (1) term project. Students will be split into groups of 3–4 people and must submit joint work for the case study, but submit independent work for term project (behavioral biases in business media). Case Study grade and Term Project I grade may vary across group members based on the in-class participation during the discussion.

(3) All students must comply with University policies for conduct and academic honesty at all times during this course. These policies are outlined in the Notre Dame Academic Code of Honor Handbook at [www.nd.edu/~hnrcode](http://www.nd.edu/~hnrcode). Any violations of these policies will result in referral to the appropriate administrative body. Exams are expected to be completed according to the specified conditions, without the assistance of others. Giving or receiving help of any kind on an exam is a violation of the Honor Code. Homework assignments can be done in
group of four (max) to encourage learning and collaboration among peers. However, I expect students to have full understanding of any written material submitted with their names on it.

RULES OF CONDUCT:

(1) Attendance will not be taken. However, students are responsible for all material and assignments presented in class.
(2) Students are expected to actively be involved in discussions.
(3) Solutions to past exams: only partial solutions will be distributed.
(4) Students are expected to hand in assignments on time.
(5) Students are expected to be respectful of their colleagues and professor. This implies:
   a) no open laptops (unless for taking note or required for the class work)
   b) similar for newspapers
   c) any discussion should involve a professor

GRADE:
Final grades will be curved to reflect a student’s performance relative to that of the entire class (all three sessions) on the following components:

<table>
<thead>
<tr>
<th>Component</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case Study</td>
<td>15%</td>
</tr>
<tr>
<td>Term Project</td>
<td>10%</td>
</tr>
<tr>
<td>Midterm</td>
<td>30%</td>
</tr>
<tr>
<td>Cumulative final</td>
<td>45%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

IMPORTANT DATES:

- September 11th – Case (6th class)
- September 16th – Mid (7th class)
- ~ October 10th – Term Project (due exam date)

NOTA BENE:

The lecture notes and handouts used in this course contain copyrighted materials. Please do not distribute without my written consent.

COURSE LITERATURE:

There are no required readings for this course apart from the lecture notes and handouts distributed in class. Some of the course material is based on the sources listed below. Students which would like to have understanding of the area beyond the level expected in the course may consider consulting with these sources.

Journal articles could be obtained on the Internet through the library. Book chapters would be available from instructor upon request.
Popular sources:
Ariel, Dan, Predictably Irrational

Academic Books and Review Articles:
Shleifer, Andrei, 2000, Inefficient Markets: An Introduction to Behavioral Finance
Ross, Stephen, 2005, Neoclassical Finance

Survey Article:
Barberis, Nicholas, and Richard Thaler, 2002, A Survey of Behavioral Finance,

Limits to arbitrage -1:
1. Mitchell, Mark, Todd Pulvino and Erik Stafford, 2002, Limited arbitrage in equity markets,
Journal of Finance, Vol 57, pp.551-584
2. Lamont, Owen, Go Down Fighting: Short Sellers vs. Firms, working paper, Yale School of Management
5. Battalio, Robert and Paul Schultz, Hastily Implementing Rules that are not Well Thought Out: The Impact of the 2008 Short Sale Ban on Equity Option Markets, working paper, University of Notre Dame

Limits to arbitrage -2:

Limits to arbitrage -3 (Closed-end fund puzzle):
2. Shleifer, Andrei, “Inefficient Markets”, Ch.3.
5. Ross, Stephen, Neoclassical Finance.

Biases in Decision Making; Prospect Theory
Relativity and Anchoring
1. Ariely, Ch1.

Herding

Mental Accounting

Stock Return Predictability, Overreaction and Underreaction

Attention anomalies
2. Tetlock, Paul, 2009, All the News that’s Fit to Reprint: Do investors React to Stale Information?, working paper

Framing

Group Process
1. Shefrin, Ch.9.

Behavioral Biases in M&As

Incentives
Fairness

Happiness