Behavioral Finance

**Topics Course:** taught by Dr. Stephan Müller (Visiting Professor)

**Outline:**

In the WS 2018/2019 we provide a topics course on behavioral finance. As a research area behavioral finance subsumes the theoretical and empirical work which challenges the efficient market hypothesis. Its “behavioral” perspective considers the joint consequences of i) limited arbitrage and ii) investors with not-fully rational beliefs or non-standard preferences.

The first part of the course is a lecture which presents important behavioral theories such as (cumulative) prospect theory, regret theory, and reference-dependent preferences. The lecture will be complemented by weekly exercises. The second part is constituted by participants’ presentations in class of one specific topic of behavioral finance. Topics and primary literature will be provided. Participants will have to write a referee report for one selected research paper.

**Participants:**

This course is primarily intended for students in the second year of the master program. Students in the finance profile of the MEP will have priority. As the number of participants will be limited, a pre-registration until September the 30th, 2018 is required. Please send your transcript and a short CV to sekretariat@finance.uni-freiburg.de.

**Prerequisites:** *Principles of Finance*

**Course Schedule:**

- Wednesdays, 6-8pm, room 2121,
- Thursdays, 4-6pm, room 1221.

The first meeting is scheduled on Wednesday, October 17th, at 6pm, in room 2121 KGII.

**ECTS (credit points):** 8 ECTS points based on

- Presentation performance,
- A referee report (3-5pp., due to 09.01.2019),
- 60 min. Written exam in December,
- Participation.

The course can be dropped without penalty until November the 15th, 2018. Thereafter withdrawal will count as a failed examination attempt!
### 1. Market Efficiency

**Topic 1. a)** The Efficient Markets Theory and the Movement toward Behavioral Finance

<table>
<thead>
<tr>
<th>Papers</th>
<th>Papers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The Efficient Market Hypothesis and its Critics</td>
<td>• The Efficient Market Hypothesis and its Critics</td>
</tr>
<tr>
<td>Burton Malkiel (2003), <em>Journal of Economic Perspectives</em> 17, 59-82,</td>
<td>Burton Malkiel (2003), <em>Journal of Economic Perspectives</em> 17, 59-82,</td>
</tr>
<tr>
<td>• From Efficient Markets Theory to Behavioral Finance</td>
<td>• From Efficient Markets Theory to Behavioral Finance</td>
</tr>
</tbody>
</table>

**Topic 1. b)** Market Bubbles – Experimental Evidence

<table>
<thead>
<tr>
<th>Papers</th>
<th>Papers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Bubbles, Crashes, and Endogenous Expectations in Experimental Spot Asset Markets</td>
<td>• Bubbles, Crashes, and Endogenous Expectations in Experimental Spot Asset Markets</td>
</tr>
<tr>
<td>• Bubbles and Experience: An Experiment</td>
<td>• Bubbles and Experience: An Experiment</td>
</tr>
<tr>
<td>• Thar She Bursts: Reducing Confusing Reduces Bubbles</td>
<td>• Thar She Bursts: Reducing Confusing Reduces Bubbles</td>
</tr>
</tbody>
</table>

### 2. Decision under Uncertainty

**Topic 2. a)** Heuristics, Biases and the Hot-Hand Phenomenon

<table>
<thead>
<tr>
<th>Papers</th>
<th>Papers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Judgment under Uncertainty: Heuristics and Biases</td>
<td>• Judgment under Uncertainty: Heuristics and Biases</td>
</tr>
<tr>
<td>• Does the Basketball Market Believe the „Hot-Hand“?</td>
<td>• Does the Basketball Market Believe the „Hot-Hand“?</td>
</tr>
</tbody>
</table>

**Topic 2. b)** Prospect Theory and its Application

<table>
<thead>
<tr>
<th>Papers</th>
<th>Papers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Prospect Theory: An Analysis of Decision under Risk</td>
<td>• Prospect Theory: An Analysis of Decision under Risk</td>
</tr>
<tr>
<td>Daniel Kahneman and Amos Tversky (1979), <em>Econometrica</em> 47, 263-291,</td>
<td>Daniel Kahneman and Amos Tversky (1979), <em>Econometrica</em> 47, 263-291,</td>
</tr>
<tr>
<td>• Toward a Positive Theory of Consumer Choice</td>
<td>• Toward a Positive Theory of Consumer Choice</td>
</tr>
<tr>
<td>3. Loss Aversion</td>
<td></td>
</tr>
<tr>
<td>------------------</td>
<td></td>
</tr>
<tr>
<td><strong>Topic 3. a)</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Papers</strong></td>
<td></td>
</tr>
</tbody>
</table>
| An Experiment on Risk Taking and Evaluation Periods  
| The Effect of Myopia and Loss Aversion on Risk Taking: An Experimental Test  
  Richard Thaler, Amos Tversky, Daniel Kahneman, and Alan Schwartz (1997), *Quarterly Journal of Economics* 112, 647-661,  
| The Equity Premium Puzzle  

| **Topic 3. b)**  |
| **Papers**       |
| The Endowment Effect  
  Experimental Tests of the Endowment Effect and the Coase Theorem  
  Daniel Kahneman, Jack Knetsch, and Richard Thaler (1990), *Journal of Political Economy* 98, 1325-1348,  
| Does Market Experience Eliminate Market Anomalies?  

<table>
<thead>
<tr>
<th>4. Risk and Ambiguity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Topic 4. a)</strong></td>
</tr>
<tr>
<td><strong>Papers</strong></td>
</tr>
</tbody>
</table>
| The Role of Risk Preferences  
  Risk Aversion and Incentive Effects  
  Charles Holt and Susan Laury (2002), *American Economic Review* 92, 1644-1655,  
| Individual Risk Attitudes: Measurement, Determinants, and Behavioral Consequences  

| **Topic 4. b)**  |
| **Papers**       |
| Ambiguity Aversion & the Home Bias  
  Ambiguity Aversion and Comparative Ignorance  
  Craig Fox, and Amos Tversky (1995), *Quarterly Journal of Economics* 110, 585-603,  
| Home Bias at Home: Local Equity Preference in Domestic Portfolios  

| **Topic 4. c)**  |
| **Papers**       |
| Ambiguity Aversion on Markets  
  Reaction to Public Information in Markets: How Much does Ambiguity Matter?  
  Brice Corgnet, Praveen Kujal, and David Porter (2013), *Economic Journal* 123, 699-737,  
| Does Ambiguity Aversion Survive in Experimental Markets?  
### 5. Investor Psychology

#### Topic 5. a) Overconfidence on Financial Markets

**Papers**

- Overconfidence of Professionals and Lay Men: Individual Differences Within and Between Tasks?
- Boys will be Boys: Gender, Overconfidence, and Common Stock Investment

#### Topic 5. b) The Role of Weather Effects

**Papers**

- Stock Prices and Wall Street Weather
- Weather and Intraday Patterns in Stock Returns and Trading Activity
  Shao-Chi Chang, Sheng-Syan Chen, Robin Chou, and Yueh-Hsiang Lin (2008), *Journal of Banking & Finance* 32, 1754-1766,
- Spanish Stock Returns: Where is the Weather Effect?

#### Topic 5. c) The Influence of Mental Accounting

**Papers**

- Mental Accounting Matters
  Robert Thaler (1999), *Journal of Behavioral Decision Making* 12, 183-206,
- Do Investors Integrate Losses and Segregate Gains? Mental Accounting and Investors Trading Decisions

### 6. Market Phenomena

#### Topic 6. a) Investors and the Disposition Effect

**Papers**

- The Disposition to Sell Winners too Early and Ride Losers too Long: Theory and Evidence
  Hershel Shefrin and Meir Statman (1985), *The Journal of Finance* 40, 777-790,
- The Disposition Effect in Securities Trading: An Experimental Analysis
  Martin Weber and Colin Camerer (1998), *Journal of Economic Behavior* 33, 167-184,
- The Disposition Effect in Team Investment Decisions: An Experimental Analysis
<table>
<thead>
<tr>
<th>Topic 6. b)</th>
<th>Herding on Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Papers</td>
<td></td>
</tr>
</tbody>
</table>
| • Learning from the Behavior of Others: Conformity, Fads and Informational Cascades  
Sushil Bikchandani, David Hirshleifer, and Ivo Welch (1998), *Journal of Economic Perspectives* 12, 151-170,  
• Herding and Contrarian Behavior in Financial Markets: An Internet Experiment  
Matthias Drehmann, Jörg Oechssler, and Andreas Roider (2005), *American Economic Review* 95, 1403-1426,  
• An Empirical Analysis of Herd Behavior in Global Stock Markets  

<table>
<thead>
<tr>
<th>Topic 7. a)</th>
<th>How Regret Influences Decision Making</th>
</tr>
</thead>
<tbody>
<tr>
<td>Papers</td>
<td></td>
</tr>
</tbody>
</table>
| • Anticipated Regret, Expected Feedback and Behavioral Decision Making  
Marcel Zeelenberg (1999), *Journal of Behavioral Decision Making* 12, 93-106,  
• Brain, Emotion and Decision Making: The Paradigmatic Example of Regret  
• Interdependent Utilities: How Social Ranking Affects Choice Behavior  

<table>
<thead>
<tr>
<th>Topic 7. b)</th>
<th>Hormones and their Impact on Risk Taking and Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Papers</td>
<td></td>
</tr>
</tbody>
</table>
| • Testosterone and Financial Risk Preferences  
• Oxytocine Increases Trust in Humans  
Michael Kosfeld, Markus Henrichs, Paul Zak, Urs Fischbacher, and Ernst Fehr (2005), *Nature* 435, 673-676.  
• Testosterone Decreases Trust in Socially Naïve Humans  
Peter Bos, David Terburg, and Jack van Honk (2010), *Proceedings of the National Academy of Sciences* 107, 9991-9995. |