BEHAVIORAL FINANCE

May 28, 2024

Program: The Graduate School of Finance (GSF), Aalto University School of Business

Credits: 6 ECTS

Timing: June 10-14, 2024

Professor: Markku Kaustia, email markku.kaustia@aalto.fi

Class sessions: See course home page at http://gsf.aalto.fi/bf.html

Exam: August 12, 2024. Please register on course home page.

Term paper: Due June 30, 2024.

1. OVERVIEW

Behavioral Finance is an approach to the analysis of asset prices, corporate finance – and financial decision-making in general – that relaxes some key assumptions of neoclassical financial economics. Namely, it considers a larger class of objective functions, not always compatible with expected utility. Second, it entertains the possibility that expectations can be biased, i.e., not always formed and updated in a fully Bayesian manner. Third, it considers how financial market frictions can form 'limits of arbitrage'. We cover these three building blocks, and apply the behavioral approach to the following topic areas: investment behavior of individuals and household finance more generally, asset pricing, and corporate finance. We also occasionally discuss methodological issues, such as empirical identification. On the whole, this course is designed to introduce doctoral students to these concepts, and to support them in developing behavioral research ideas of their own.

2. CLASS SCHEDULE AND TOPICS

See Section 6. for full references to the reading material. Note that papers to analyze and discuss are listed in the schedule and not repeated in Section 6.

Day 1 - Behavioral beliefs

Topics: Introduction to course and human behavior; Judging and forecasting sequences; Anchoring; Overconfidence; Biased learning.

Before class:

- Watch Daniel Kahneman's interview https://www.youtube.com/watch?v=l4zSc2lYl60 (6 min).
- Read introduction –section of Chen, Moskowitz, and Shue (2016).
- Paper to analyze and discuss: Chen, 2013, "The Effect of Language on Economic Behavior: Evidence from Savings Rates, Health Behaviors, and Retirement Assets", *American Economic Review* 103(2), 690-731.
- The 'analyze and discuss' -assignment above designates one paper for each day that is related to the day's themes (though can also be related to other days' themes), as well as has other convenient pedagogical properties. Read this paper beforehand and think about issues such as the intended contribution, to what degree are you convinced and why, and what possible follow-up research would be relevant. During classes, we'll discuss it together and in small groups.

Related readings: Kaustia and Knüpfer (2008); Kaustia and Perttula (2012).

Day 2 - Behavioral preferences

Topics: Evaluating present versus future; Evaluating risky outcomes by prospect theory; Risk-preference dynamics.

Before class:

- Cursory read of Ariely, Loewenstein, and Prelec (2006) [10 pages].
- Paper to analyze and discuss: Heimer, Rawley Z., Zwetelina Iliewa, Alex Imas, and Martin Weber, 2024, "Dynamic inconsistency in risky choice: Evidence from the lab and field", (SSRN version), *American Economic Review*, Forthcoming.

Related readings: Benartzi and Thaler (1999); Kaustia (2010).

Day 3 - Retail investor behavior

Topics: Credit card debt; Portfolio selection; Mutual fund choice; Trading performance and mistakes.

Before class:

- Watch Richard Thaler's interview https://www.youtube.com/watch?v=BWUtLSfb9zs (16 min)
- Paper to analyze and discuss: Sias, Richard, Laura T. Starks, and H.J. Turtle, 2023, "The negativity bias and perceived return distributions: Evidence from a pandemic", *Journal of Financial Economics* 147, 627-657.

Related readings: Meier and Sprenger (2010); Barber and Odean (2013); Kaustia, Conlin, and Luotonen (2023).

Day 4 - Asset pricing applications

Topics: Inefficient markets; Limits of arbitrage; Excess volatility, Investor sentiment

Before class:

- Watch Robert Shiller's Nobel Prize Lecture at nobelprize.org (32 min) and/or read Shiller (2003) [20 pages].
- Paper to analyze and discuss: Edmans, Alex, Adrian Fernandez-Perez, Alexandre Garel, Ivan Indriawan, 2022, "Music sentiment and stock returns around the world", *Journal of Financial Economics* 145, 234-254.

Related readings: Shleifer and Vishny (1997), Barberis, Shleifer, and Vishny (1998); Baker and Wurgler (2006).

Day 5 - Corporate finance applications and empirical methods

Topics: Biased managers; Biased markets; Other empirical applications

Before class:

- Read introduction sections of Kaustia and Torstila (2011, on stock market aversion), Kaustia and Knüpfer (2012, on peer performance and stock market entry), and Kaustia and Rantala (2015, on corporate peer effects).
- Paper to analyze and discuss: Kaplan, Steven N., Morten Sørensen, and Anastasia A. Zakolyukina, 2022, "What is CEO overconfidence? Evidence from executive assessments", *Journal of Financial Economics* 145, 409-425.

Related readings: Malmendier and Tate (2015); Shleifer and Vishny (2003), Savor and Lu (2009).

3. REQUIREMENTS AND GRADE COMPONENTS

- Class participation 10%. This grade component reflects the quantity and quality of overall contribution to class discussion.
- Term paper 30%. The topic can be one of the following: 1. A research idea with some preliminary analysis; 2. An analysis of the behavioral aspects of an existing financial product or service; 3. An idea for a new investment product or a household finance product. In all of the above cases the analysis needs to be deeply rooted in behavioral finance research, possibly augmented with research in other social sciences. The required format: Max 10 pages, including everything (double spaced, font 12pt Times, 2.5cm margins).
- Final exam 60%. The exam covers all course material, including lectures, and the material indicated in the syllabus, and any possible later additions. It is 'closed book' format, meaning that no material is allowed.
- Passing the course requires 50% from exam and 50% from term paper.

4. CLASS PRACTICALITIES THAT STUDENTS NEED TO KNOW

- The course is meant for students who want to be an active part of the learning experience. This involves taking part in class discussions. I use various techniques, including sometimes calling on individual students.
- It is your responsibility to reach out and ask (during or after the lecture) if you are confused by any class content, or if any other issue about the course is bothering you.
- The slides are designed for providing exhibits and summarizing main points. This means they are helpful if you attend the lectures, but they are not meant to be standalone reading.

5. SCHOLASTIC HONESTY AND ACADEMIC INTEGRITY

We expect adherence to highest standards of scholastic honesty. Examples of scholastic dishonesty are exercise answer sharing between groups, presenting text produced by another author as own work without proper citation (plagiarism) or sharing answers during the final exam. All class work is to be done individually, unless specifically otherwise instructed. Failure to adhere to these guidelines is subject to disciplinary action, such as removal from the course.

6. READINGS

Ariely, Dan, George Loewenstein, Drazen Prelec, 2006, "Tom Sawyer and the construction of value", *Journal of Economic Behavior and Organization* 60, 1-10.

Baker, Malcolm and Jeffrey Wurgler, 2006, "Investor sentiment and the cross-section of stock returns", *Journal of Finance* 61(4), 1645-1679.

Barber, Brad and Terrance Odean, 2013, "The Behavior of Individual Investors", in Handbook of Economics of Finance, Vol 2, eds. G. Constatinides, H. Harris, and R. Stulz, Elsevier Publishing.

Barberis, Nicholas, Andrei Shleifer, and Robert Vishny, 1998, "A model of investor sentiment", *Journal of Financial Economics* 49, 308-343.

Benartzi, Shlomo and Richard H. Thaler, 1999, "Risk aversion or myopia? Choices in repeated gambles and retirement investments", *Management Science* 45(3), 364-381.

Chen, D., T. Moskowitz, and K. Shue, 2016, "Decision-Making under the Gambler's Fallacy: Evidence from Asylum Judges, Loan Officers, and Baseball Umpires", Quarterly Journal of Economics 131(1), 1181-1242.

Kaustia, Markku, 2010, "Disposition Effect", Chapter 10 in Behavioral Finance: Investors, Corporations, and Markets, H. Kent Baker and John R. Nofsinger (eds), John Wiley & Sons, Inc.

Kaustia, Markku, Andrew Conlin, and Niilo Luotonen, 2023, "What drives stock market participation? The role of institutional, traditional, and behavioral factors", *Journal of Banking & Finance* 148.

Kaustia, Markku and Samuli Knüpfer, 2008, "Do investors overweight personal experience? Evidence from IPO subscriptions", *Journal of Finance* 63(6), 2679-2702.

Kaustia, Markku and Samuli Knüpfer, 2012, "Peer performance and stock market entry", *Journal of Financial Economics* 104, 321-338.

Kaustia, Markku and Milla Perttula, 2012, "Overconfidence and debiasing in the financial industry", *Review of Behavioral Finance*, 4(1), 46-62.

Kaustia, Markku and Ville Rantala, 2015, "Social learning and corporate peer effects", *Journal of Financial Economics* 117(3), 653-669.

Kaustia, Markku and Sami Torstila, 2011, "Stock market aversion? Political preferences and stock market participation", *Journal of Financial Economics* 100(1), 98-112.

Malmendier, Ulrike, and Geoffrey Tate, 2015, "Behavioral CEOs: The role of managerial overconfidence", *Journal of Economic Perspectives* 29(4), 37-60.

Meier, Stephan and Charles Sprenger, 2010, "Present-biased preferences and credit card borrowing", *American Economic Journal: Applied Economics* 2(1), 193-210.

Savor, Pavel G. and Qi Lu, 2009, "Do stock mergers create value for acquirers?", *Journal of Finance* 64(3), 1061-1097.

Shiller, Robert J., 2003, "From efficient market theory to behavioral finance", *Journal of Economic Perspectives* 17(1), 83-104.

Shleifer, Andrei and Robert W. Vishny, 1997, "The limits of arbitrage", *Journal of Finance* 52(1), 35-55.

Shleifer, Andrei and Robert W. Vishny, 2003, "Stock market driven acquisitions", *Journal of Financial Economics* 70(3), 295-311.