TOPICS IN FINANCIAL ECONOMICS: BEHAVIORAL FINANCE

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The course will introduce the rapidly growing field of behavioral finance; that is, the study of finance when the ‘rational agent’ paradigm is relaxed. We will start with introducing a list of ‘puzzles’ in finance, that is, empirical facts that are possibly hard to explain using the standard models of finance (with rational agents). We will then survey the deviations from rationality which have been documented with experimental data by cognitive psychologists (and more recently by economists as well). These will include both deviation from Bayesian updating and deviation from optimality of choice. Finally we will study several models that have been introduced in finance which account from these deviations from rationality to explain the ‘puzzles.’ A more detailed list of topics follows.

- Efficient Markets: A review.
  We will review the received theory of efficient capital markets as e.g., in Cochrane’s book. Implications of efficient markets for arbitrage, asset pricing, information updating etc.

- Financial markets puzzles.
  Typical puzzles include: risk premium, excess volatility, closed end fund, professional arbitrage, twin shares, index inclusions, internet carve outs, etc.

- Limits to arbitrage theory.
  Can less than rational agents co-exist with rational ones? or Is it that the rational agents will always make infinite profits (with probability 1) off the irrational ones? In the last case, behavioral finance is of very limited interest. Under which conditions is it possible then that rational and irrational agents co-exist? that is, Under which conditions is arbitrage limited?
• Evidence on behavioral phenomena.

Behavioral phenomena regarding updating include:
  Overconfidence
  Optimism/Wishful thinking
  Representativeness
  Anchoring
  Perseverance

Behavioral phenomena regarding choice include:
  Different forms of non-expected-utility
  Ambiguity aversion
  Hyperbolic discounting

• A survey of models used in behavioral finance.

We will read several of the most accomplished papers in the field. Examples:


• Notes on the empirical evaluation behavioral finance models.

What have we learned? Which of the ‘puzzle’ are solved? How well does behavioral finance do empirically? Do we overfit the data? that is, Do we need a different form of irrationality to explain each puzzle?

Besides the papers we will read, listed above (others will be added), there is a series of useful general references and surveys:


Journal of Economic Perspectives.

