Princeton University FALL 2005

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ECO575/FIN575: Topics in Financial Economics

Time and Location:

Part I: Sept. – Oct. 15: TTh 3:00 pm - 4:30 pm, Room 317, Bendheim Hall
Part II: Oct. 18 – Dec.: MW 4:30 pm - 6:00 pm, Room 317, Bendheim Hall

Aim of the Course:

The course is designed as a topics course for second and third year PhD students, who want to specialize in Financial Economics. Thorough knowledge of game theory and general equilibrium theory as taught in the first year Microeconomics course is assumed. Master and undergraduate students can also attend in the course.
Aim of the course is to bring students to the research frontier and help them to conduct independent research in finance. This course is split in two parts. The first part will be taught by Prof Hong, the second part by Prof. Brunnermeier. We plan to make this course very interactive and incorporate student presentations. Additional course material will be made available on our websites.

Structure of the Course:

Part I: (Prof. Hong)

A) MARKET EFFICIENCY:
1. Introduction to Market Efficiency
2. Arguments and Evidence

B) LIMITS TO ARBITRAGE

C) OVER- AND UNDERREACTION
1. Evidence
2. Theories and Further Evidence

D) INVESTOR BEHAVIOR

Part II: (Prof. Brunnermeier)

A) ASSET PRICING UNDER ASYMMETRIC INFORMATION

1. Market Microstructure Models
   - Rational Expectations Equilibrium versus Bayesian Nash Equilibrium Concept
   - Insider Trading Models and Sequential Trade Models
   - Share Auctions

2. Allocative and Informational Efficiency
3. Higher Order Uncertainty, No-Trade Theorems

B) LIMITS TO ARBITRAGE AND BUBBLES
1. Noise trader risk (myopic versus long horizons)
2. Synchronization Risk

C) BELIEF BIASES
1. List of Psychological Biases
2. The Optimal Expectations Framework

D) LIQUIDITY ASSET PRICING – INSTITUTIONAL FINANCE
   1. LTCM case and Predatory Trading
   2. Funding Liquidity versus Market Liquidity
   3. Consumer Liquidity demand - Bank runs
   4. Credit Cycles
   5. Liquidity Asset Pricing

E) INTRODUCTION TO INFORMATION THEORY

* Given the time constraints, we cannot guarantee that all topics will be covered.

<u>Detailed Reading List:</u>

<u>PART I:</u>

A) MARKET EFFICIENCY

1. Introduction

Summers, Lawrence H., 1985, On economics and finance, Journal of Finance 40, 633-635.

2. Arguments and Evidence

Froot, Kenneth and Emil Dabora, 1999, How are stock prices affected by the location of trade? Journal of Financial Economics 53, 189-216.

Jensen, Michael, 1978, Some anomalous evidence regarding market efficiency, Journal of Financial Economics 6, 95-101.

Klibanof, Peter, Owen Lamont and Thierry Wizman, 1998, Investor reaction to salient news in closed-end country funds, Journal of Finance 53, 673-699.

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Lee, C.M., A. Shleifer and R. Thaler, 1991, Investor sentiment and the closed-end fund puzzle, Journal of Finance 46, 75-110.

Mitchell, Mark, Todd Pulvino and Erik Stafford, 2002, Limited arbitrage in equity markets, Journal of Finance 57, 551-584.

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Shleifer, Andrei, 1986, Do demand curves for stocks slope down? Journal of Finance 41, 579-90.

Summers, Lawrence H., 1986, Does the stock market rationally reflect fundamental values? Journal of Finance 41, 591-601.

B) LIMITS TO ARBITRAGE - INTRODUCTION

Chen, Joseph, Harrison Hong, Ming Huang and Jeffrey D. Kubik, 2003, Does fund size erode mutual fund performance? The role of liquidity and organization, Princeton University Working Paper.

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Cohen, Randolph, Paul Gompers and Tuomo Vuolteenaho, 2003, Who underreacts to cash-flow news? Evidence from trading between individuals and institutions, Journal of Financial Economics, forthcoming.

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Scharfstein, David and Jeremy C. Stein, 1990, Herd behavior and investment, American Economic Review 80, 465-479.

Shleifer, Andrei and Robert W. Vishny, 1997, The limits of arbitrage, Journal of Finance 52, 35-55.

Stein, Jeremy, 2003, Why are most funds open-end? Competition and the limits of arbitrage, Harvard University Working Paper.

C) OVER- AND UNDERREACTION

1. Evidence

Bernard, Victor, 1992, Stock price reactions to earnings announcements, in Richard Thaler (ed.) Advances in Behavioral Finance. New York, Russell Sage Foundation.

Campbell, John, 1998, Asset prices, consumption and the business cycle, in Taylor and Woodford (eds.) Handbook of Macroeconomics, North-Holland.

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Fama, Eugene F., 1998, Market efficiency, long-term returns and behavioral finance, Journal of Financial Economics 49, 283-306.

Fama, Eugene and Ken French, 1998, Value versus growth: The international evidence, Journal of Finance 53, 1975-1999.

Fama, Eugene and Ken French, 1992, The cross-section of expected stock returns, Journal of Finance 47, 427-465.

Fama, Eugene and Ken French, 1988, Dividend yields and expected stock returns, Journal of Financial Economics 22, 3-25.

Jegadeesh, N. and Sheridan Titman, 1993, Returns to buying winners and selling losers: Implications for stock market efficiency, Journal of Finance 48, 65-91.

Lakonishok, Josef, Andrei Shleifer and Robert W. Vishny, 1994, Contrarian investment, extrapolation and risk, Journal of Finance 49, 1541-1578.

La Porta, R., 1996, Expectations and the cross-section of returns, Journal of Finance 51, 1715-1742.

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2. Theories and Further Evidence

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Benartzi, Shlomo and Richard Thaler, 1995, Myopic loss aversion and the equity premium puzzle, Quarterly Journal of Economics 110, 75-92.

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D) INVESTOR BEHAVIOR

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French, Kenneth, and James Poterba, 1991, Investor diversification and international equity markets, American Economic Review 81, 222-226.

Genesove, David and Christopher Mayer, 2001, Loss aversion and seller behavior: Evidence from the housing market, Quarterly Journal of Economics 116, 1233-1260.

Grinblatt, Mark and Matti Keloharju, 2001, Distance, language and culture bias: The role of investor sophistication, Journal of Finance 56, 1053-1073.

Hong, Harrison, Jeffrey D. Kubik and Jeremy C. Stein, 2002, Social interaction and stock market participation, Journal of Finance, forthcoming.

Hong, Harrison, Jeffrey D. Kubik and Jeremy C. Stein, 2002, Thy neighbor's portfolio: Word-of-mouth effects in the holdings and trades of money managers, Princeton University Working Paper.

Glaeser, Edward L., and Jose Scheinkman, 2000, Non-market interactions, NBER Working Paper.

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PART II

A) ASSET PRICING UNDER ASYMMETRIC INFORMATION

Markus K. Brunnermeier, *Asset Pricing under Asymmetric Information - Bubbles, Technical Analysis, Herding and Crashes*, Oxford University Press, Jan. 2001 CHAPTER 1-3. (see detailed references in this book)

B) LIMITS TO ARBITRAGE AND BUBBLES

Andrei Shleifer, *Inefficient Markets – An Introduction to Behavioral Finance*, Oxford University Press, 2000

DeLong, J. Bradford, Andrei Shleifer, Lawrence H. Summers and Robert Waldmann, 1990a, Noise trader risk in financial markets, Journal of Political Economy 98, 703-738.

Abreu, Dilip and Markus Brunnermeier, 2003, Bubbles and crashes, Econometrica 71, 173-204.

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Diamond, D.W., Verrecchia, R.E., 1987. Constraints on short-selling and asset price adjustment to private information. Journal of Financial Economics 18, 277-311.

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Hong, Harrison, Jose Scheinkman, and Wei Xiong, 2003, Asset float and speculative bubbles, Princeton University Working Paper.

Kandel, E., Pearson, N.D., 1995, Differential interpretation of public signals and trade in speculative markets, Journal of Political Economy 103, 831-72.

Lamont, Owen and Charles Jones, 2002, Short-sales constraints and stock returns, Journal of Financial Economics 66, 207-239.

Miller, Edward, 1977, Risk, uncertainty and divergence of opinion, Journal of Finance 32, 1151-1168.

Morris, S., 1996, Speculative investor behavior and learning, Quarterly Journal of Economics 111, 1111-1133.

Ofek, Eli and Matthew Richardson, 2003, Dot-com mania: Market inefficiency in the internet sector, Journal of Finance, forthcoming.

Scheinkman, Jose and Wei Xiong, 2003, Overconfidence and speculative bubbles, Journal of Political Economy, forthcoming.

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Cutler, David M., Poterba, James M. and Summers, Lawrence H., 1989, What moves stock prices? Journal of Portfolio Management 15, 4-12.

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Pindyck, Robert S., 1984, Risk, inflation, and the stock market, American Economic Review, 74, 334-351.

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Romer, David, 1993, Rational asset-price movements without news, American Economic Review 83, 1112-30.

C) BELIEF BIASES

1. List of Psychological Biases

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2. The Optimal Expectations Framework

Brunnermeier, Markus K. and Jonathan Parker, "Optimal Expectations", working paper Princeton University

Gollier, Optimal Illustions and Decisions under Risk, Working paper, University of Toulouse…

D) LIQUIDITY ASSET PRICING – INSTITUTIONAL FINANCE

1. LTCM and Predatory Trading

Brunnermeier, Markus K. and Lasse Pedersen, Predatory Trading, Journal of Finance (forthcoming).

2. Funding Liquidity versus Market Liquidity

Grossman, Sandy and Merton Miller, 1988, Liquidity and Market Structure, Journal of Finance 43, 617-633.

Brunnermeier, Markus K. and Lasse Pedersen, Funding Liquidity and Market Liquidity, mimeo.

3. Consumer Liquidity demand – Bank runs

Diamond, Douglas and Phil Dybvig, Bank runs, deposit insurance, and liquidity, Journal of Political Economy 1993

Freixas and Rochet, *Microeconomics of Banking*, MIT Press, 1999

4. Credit Cycles – Balance Sheet Effects

Kyotaki, Nobu and John Moore, 1997, Credit Cycles, Journal of Political Economy 105, 211-248.

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5. Liquidity Asset Pricing

Holmström and Tirole, 1998, Private and public supply of liquidity, Journal of Political Economy 106, 1-40.

Holmström and Tirole, 2001, LAPM: A Liquidity-Based Asset Pricing Model, Journal of Finance 56, 1837-1867.

E) BRIEF INTRODUCTION TO INFORMATION THEORY

Cover, Thomas M. and Joa A. Thomas, Information Theory, Wiley. 1991

Sims, Chris “Rational Inattention”, Working paper, Princeton University