

**The University of Hong Kong  
Faculty of Business and Economics**

**MFIN7015 Behavioral Finance  
Summer 2013**

**Instructor:**

Dr. Chun Xia  
Email: chunxia@hku.hk  
Tel: 28591052

**Time and Venue:**

July 2- August 8, Tuesday and Thursday, 6:45-9:45pm  
B2, Admiralty Town Center

**Course Description:**

Since 1950s, finance researchers have developed a highly successful paradigm based on the notions that investors and managers are generally rational, or even if they are not, a few smart arbitrageurs can spot the mispricing and make a correction through trading. As a consequence, the prices of securities, the asset allocation of assets, and the management of corporations are “efficient”. In recent years, however, anecdotal evidence as well as theoretical and empirical research has shown this paradigm to be insufficient to describe various features of actual financial markets and corporation world.

Behavioral finance uses insights from psychology to understand how biases, heuristics, emotions, and social forces influence the decisions of investors and managers. We describe how and why these suboptimal decisions might deviate from those predicted by traditional finance or economic theory. We explore the implications of investor psychology and limitation to arbitrage on the investor trading behaviors, aggregate stock market and the cross-section of average returns, and corporate finance. Probably the most interesting feature of this course is that we show how successful hedge funds overcome the limits to arbitrage and construct investment strategies to exploit other investors’ biases, emotions, etc., and during this process the markets become more efficient.

**Course Website:**

The Moodle course website can be accessed from your HKU portal under the eLearning menu.

**Prerequisites:**

Students should have knowledge on asset valuation at postgraduate level.

## **Course Material and References:**

The teaching is closely based on the following textbook (The MFIN office will arrange the bookstore to sell the book in Admiralty Town Center or you can buy it from Amazon) even though I will provide very informative updates, so owning the book is **required**.

**Lucy Ackert and Richard Deavers, 2009, *Behavioral Finance: Psychology, Decision-Making, and Markets*, South Western**

I reserve the copyrights for course structure and lecture notes. The original authors reserve the copyrights for sample research slides, reports, and published articles.

## **Objectives:**

The major objectives of this course are to help students

1. Identify key assumption differences between traditional finance and behavioral finance frameworks.
2. Understand key psychological biases that affect decision making process.
3. Apply psychology research findings into asset pricing anomalies.
4. Exploit the findings in behavioral finance into investment strategies.

## **Course Intended Learning Outcomes:**

By the end of this course, students should be able to:

- CILO1. Explain different types of investor biases and heuristics
- CILO2. Explain the impacts of biases on the aggregate and cross sectional stock market
- CILO3. Learn to construct investment strategies and build optimal portfolios that exploit psychological biases
- CILO4. Learn to overcome the behavioral biases in corporate finance

## **Alignment of Program and Course Learning Outcomes:**

<b>Program Intended Learning Objectives</b>	<b>Course Intended Learning Outcomes</b>
1. Acquisition and internalization of knowledge and techniques in the discipline of modern Finance.	CILO1, CILO2, CILO3, CILO4
2. Application and integration of knowledge in the Finance profession.	CILO1, CILO2, CILO3, CILO4
3. Mastering communication skills.	CILO1, CILO2, CILO3, CILO4
4. Inculcating professionalism and leadership.	CILO1, CILO2, CILO3, CILO4

**Target Schedule:**

<b>Week</b>	<b>Textbook</b>	<b>Topics</b>
1	Chs. 1,2,4	<b>Foundations and Challenges of Standard Finance. Limits to Arbitrage</b> Expected utility theory. Portfolio Theory. Market efficiency. Agency problem. Anomalous trading behavior, decisions and puzzling asset returns. Why is arbitrage limited?
2-3	Chs.3, 5-7	<b>Prospect Theory, Heuristics and Biases, and Emotions</b> Loss aversion. Probability weighting. Framing. Mental accounting. Representativeness. Familiarity. Anchoring. Overconfidence. Excessive optimism.
4-5	Chs. 8-12	<b>Investor Decision Making</b> Limited stock participation. Equity home bias and underdiversification. Chasing winners. Attention grabbing. Disposition effect. Excessive trading.
6-7	Chs. 13-14	<b>Aggregate Market and Cross-Sectional Asset Returns</b> Equity premium puzzle. Small vs. big. Value vs. growth. Winner vs. loser. Post earnings announcement drift
8-9	Ch. 19	<b>Behavioral Investing</b> Refining value investing using accounting data. Refining momentum investing using volume. Latest behavioral investing in successful hedge funds
10-11	Chs.15-16	<b>Manager Decision Making (or Behavioral Corporate Finance)</b> Rational manager and irrational investor. Irrational manager and rational investor. IPOs, Capital structure, Mergers and Acquisitions
12		<b>Student Presentation</b> Maximum 10 minutes each group.
		<b>Final Exam</b>

**Assessment and Examination:**

- **Class Leadership (5%)**  
Raise/answer relevant questions during lecture.

<b>Grade</b>	<b>Grading Criteria for Class Leadership</b>
A+, A, A-	Extremely well prepared for class discussion, very active in sharing views and attended at least 90% of classes
B+, B, B-	Partially prepared for class discussion, active in sharing views and attended at least 80% of classes
C+, C, C-	Not well prepared for class discussion, limited active in sharing views and attended at least 70% of classes
D+, D	Not well prepared for class discussion, no sharing views and attended at least 60% of classes
F	Poorly prepared for class discussion, no sharing views and attended at least 50% of classes

- **Examination (45%)**  
Comprehensive exam with short questions and simple calculation.

Grade	Grading Criteria for Examination
A+, A, A-	Score correctly on more than 80% of questions
B+, B, B-	Score correctly on less than 80% of questions
C+, C, C-	Score correctly on less than 70% of questions
D+, D	Score correctly on less than 60% of questions
F	Score correctly on less than 50% of questions

- **In-Class Presentation and Report Writing (50%)**

The students must form groups of up to 2 members (note that this is subject to change, depending on the total enrollment) and analyze either (i) a behavioral case study or (ii) a behavioral investing strategy. Ideas and samples for strategies or case studies can be found in the textbook and provided on Moodle course webpage, but the students are encouraged to come up with their own ideas. Each group must **present the findings in class (maximum 10 minutes) and document them in a written report (in WORD or PDF). The reports and slides** are due in my email on a specified date (TBA) after the last day of class.

The group analyzing a case study must describe the involved parties and the events, analyze the underlying economic mechanisms at play, discuss the general lessons that can be learned, and are encouraged to provide academic literature, empirical evidence (if any) or estimate the returns (if you can) that corresponds to that used by the involved parties to verify anecdotal evidence.

The group analyzing a strategy must study its underlying economic rationale the relevant evidence from the academic literature (if any), the strategy's past returns using real data, estimate the associated transactions costs and use of capital /margin (if you can), and describe its success or failure using several performance measures.

Grade	Grading Criteria for Group Presentation
A+, A, A-	The presentation was highly successful at communicating the essential elements of the topic to the audience; Concepts were thoroughly explained and clarified; The presentation demonstrated deep understanding and comprehension of the topic; There was clear evidence of independent thought and reflection on the topic; The topic was covered in a highly professional and organized manner; The presenter displayed excellent verbal skills and delivered a highly interesting, coherent presentation at an appropriate level for the audience.
B+, B, B-	The presentation was successful at communicating the essential elements of the topic to the audience; Most concepts were well explained and clarified;

	<p>The presentation demonstrated sound understanding and comprehension of most aspects of the topic;</p> <p>The topic was covered in a professional and organized manner;</p> <p>The presenter displayed good verbal skills and mostly delivered an interesting, coherent presentation at an appropriate level for the audience.</p>
C+, C, C-	<p>The presentation adequately communicated most of the essential elements of the topic to the audience;</p> <p>Most concepts were adequately explained;</p> <p>The presentation demonstrated good understanding and comprehension of most aspects of the topic;</p> <p>The topic was covered in an organized manner;</p> <p>The presenter displayed adequate verbal skills and mostly delivered a mostly coherent presentation at an appropriate level for the audience.</p>
D+, D	<p>The presentation basically covered the main aspects of the topic;</p> <p>The presentation demonstrated basic understanding and comprehension of most aspects of the topic;</p> <p>The topic was covered in a basic manner;</p> <p>The presenter displayed minimal standards of verbal skills, coherence, and organization.</p>
F	<p>The presentation was poorly addressed and concepts were inadequately explained;</p> <p>The presentation did not demonstrate sufficient understanding and comprehension of the topic;</p> <p>The topic was covered acceptably and/or was poorly organized;</p> <p>Verbal skills were inadequate.</p>

The report is limited to 20 pages (you do not need to write 20 pages if can use 15 pages to tell your compelling story) **excluding** cover page, references, regressions, tables, figures and appendix (if any). The specification of the **standard format** is as follows: **A4 paper, double space with minimum one-inch margin on all sides, a font of 12 Times New Roman.**

**The report will be checked by anti-plagiarism software. Zero grade point will be given if plagiarism behavior is identified.**

<b>Grade</b>	<b>Grading Criteria for Written Reports</b>
A+, A, A-	<p>All aspects were addressed and researched in great depth;</p> <p>Demonstrated a clear understanding of and the ability to apply the theory, concepts and issues relating to the topic;</p> <p>Clearly identified the most critical aspects of the task and adopted a critical perspective;</p> <p>Developed excellent argument and offered a logically consistent and well-articulated analysis and insight into the subject;</p> <p>Drew widely from academic/professional literature whilst maintaining relevance;</p> <p>All aspects conformed to a high academic/professional standard.</p>
B+, B, B-	<p>Most aspects were addressed and researched in depth;</p> <p>Demonstrated a good understanding of and some application of the</p>

	<p>theory, concepts and issues relating to the topic;  Identified the most critical aspects of the task and adopted a critical perspective;  Showed some evidence of analysis, supported by logical argument and insight into the subject;  Drew on relevant academic/professional literature;  Most aspects conformed to a high academic/professional standard.</p>
C+, C, C-	<p>Most aspects were addressed and researched adequately;  Demonstrated a good understanding of the theory, concepts and issues relating to the topic but limited application to the topic;  Some presented argument showed some insight but not always consistent and logical;  Drew upon an adequate range of academic/professional literature;  Most aspects conformed to an acceptable academic/professional standard.</p>
D+, D	<p>Basic aspects were addressed and researched adequately;  Demonstrated mainly description, showed basic understanding of the topic but no application;  Showed little evidence of analysis but no clear and logical argument relating to the subject;  Drew primarily upon course materials;  Limited aspects conformed to an academic/professional standard.</p>
F	<p>Basic aspects were superficial, inadequate or absent;  Demonstrated limited understanding of the topic and drew conclusion unrelated to the topic;  The written work was not of an academic/professional standard.</p>

### Course Policies

- As teacher I have the following responsibilities:
  - Come prepared to every class with well thought-out presentation.
  - Design class so you can accomplish cognitive objectives listed in the syllabus.
  - **Consider that it is not always your fault if you don't understand the material.**
  - Create mutually respectful classroom environment.
- As students you have the following responsibilities:
  - Come prepared to every class by reviewing notes and doing assignments.
  - Complete all work on time with proper thought.
  - **Consider that it is not always teacher's fault if you don't understand the material.**
  - **Ask questions when you don't understand. Asking question is a sign of maturity, not ignorance.**
- Academic Dishonesty

The University Regulations on academic dishonesty will be strictly enforced. Please check the University Statement on plagiarism on the web:  
<http://www.hku.hk/plagiarism/>

Academic dishonesty is behavior in which a deliberately fraudulent misrepresentation is employed in an attempt to gain undeserved intellectual credit, either for oneself or for another. It includes, but is not necessarily limited to, the following types of cases:

1. *Plagiarism - The representation of someone else's ideas as if they are one's own. Where the arguments, data, designs, etc., of someone else are being used in a paper, report, oral presentation, or similar academic project, this fact must be made explicitly clear by citing the appropriate references. The references must fully indicate the extent to which any parts of the project are not one's own work. Paraphrasing of someone else's ideas is still using someone else's ideas, and must be acknowledged.*
2. *Unauthorized Collaboration on Out-of-Class Projects - The representation of work as solely one's own when in fact it is the result of a joint effort.*
3. *Cheating on Exams - The covert gathering of information from other students, the use of unauthorized notes, unauthorized aids, etc.*

