DePaul University, Chicago, Illinois
DRIEHAUS CENTER FOR BEHAVIORAL FINANCE

PSYCHOLOGY OF FINANCIAL MARKETS

Modern investment theory says that, at all times, market prices equal fundamental value and that asset returns in the cross-section reflect relative exposures to systematic non-diversifiable risk. Despite decades of data analysis, empirical support for this theory remains thin. For instance, capital asset pricing model betas are at best weakly related to returns and there is much unexplained volatility in asset prices. Shareholder trading practices are also difficult to reconcile with the standard theory. Periods of price turbulence, accompanied by heavy trading volume, are followed by periods of relative calm.

This course is an introduction to the principles, issues, and methods of security analysis and investment strategy. We take a psychological approach as we study the determinants of asset prices and trading volume. We put great emphasis on the decision processes and the behavior of individual and institutional investors.

Topics and assignments

WEEK 1: FOUNDATIONS OF FINANCE

Werner De Bondt, "Foundations of finance." Lecture notes.

WEEK 2: RISK AND RETURN IN FINANCIAL MARKETS

Jeremy Siegel, "The equity premium: Stock and bond returns since 1802." *Financial Analysts Journal*, 1992

Gabriel Hawawini and Donald Keim, "The cross-section of common stock returns: A review of the evidence and some new findings." In D. Keim and W. Ziemba, *Security Market Imperfections in World Equity Markets*, 2000

*(recommended) Jeremy Siegel, *Stocks for the Long Run*, 2002 (3rd edition)

*(recommended) Burton Malkiel, *A Random Walk Down Wall Street*, 2002 (7th edition)

*(recommended) Robert Haugen, *The New Finance, 1995*

WEEK 3: PRICE AND VALUE ON WALL STREET

David Cutler, James Poterba, and Lawrence Summers, “What moves stock prices?” *Journal of Portfolio Management*, 1989

Robert Shiller, “Theories of aggregate stock price movements." *Journal of Portfolio Management*, 1984

Jonathan Burton, “The efficient pioneer: A conversation with Eugene Fama," *Dow Jones Investment Advisor*, 2000

*(recommended) Robert Shiller, *Irrational Exuberance*, 2000

*(recommended) Robert Shiller, “Stock prices and social dynamics.” *Brookings Papers on Economic Activity*, 1984

*(recommended) Werner De Bondt, “Bubble psychology,” in W. Hunter and G. Kaufman (eds.), *Asset Price Bubbles: Implications for Monetary, Regulatory, and International Policies*, 2002

*(recommended) Howard Kurtz, *The Fortune Tellers: Inside Wall Street’s Game of Money, Media, and Manipulation*, 2000

WEEK 4: INVESTOR PSYCHOLOGY

Paul Slovic, “Psychological study of human judgment: Implications for investment decision-making." *Journal of Finance*, 1972

Daniel Kahneman and Mark Riepe, “Aspects of investor psychology.” *Journal of Portfolio Management*, 1998

Werner De Bondt and Richard Thaler, “Financial decision-making in markets and firms: A behavioral perspective.” In R. Jarrow et al. (eds.), *Handbook of Finance*, 1995

Werner De Bondt, “A portrait of the individual investor." *European Economic Review*, 1998

Robert Shiller, “Speculative prices and popular models.” *Journal of Economic Perspectives*, 1990

*(recommended) Jonathat Burton, "At What Price? A Conversation with Jay Ritter," *Investment Advisor*, 2000

*(recommended) Thomas Gilovich, Dale Griffin, and Daniel Kahneman, *Heuristics and Biases: The Psychology of Intuitive Judgment*, 2002

WEEK 5: SUPERSTARS

Hemang Desai and Prem Jain, "An analysis of the recommendations of the superstar money managers at Barron's annual roundtable." *Journal of Finance*, 1995

Werner De Bondt, "What do economists know about the stock market?" *Journal of Portfolio Management*, 1991

John M. Keynes, *The General Theory of Employment, Interest and Money*, 1936, chapter 12

*(recommended) Scott Stickel, "Reputation and performance among security analysts." *Journal of Finance*, 1992

WEEK 6: THE QUALITY OF ANALYST EARNINGS FORECASTS

Werner De Bondt and Richard Thaler, "Do security analysts overreact?" *American Economic Review*, 1990

Werner De Bondt and William Forbes, "Herding in analyst earnings forecasts: Evidence from the United Kingdom." *European Financial Management*, 1999

Werner De Bondt, "Analyst rhetoric." Manuscript in preparation, 2002

*(recommended) Stacey Nutt, John Easterwood and Cintia Easterwood, "New evidence on serial correlation in analyst forecast errors." *Financial Management*, 1999

*(recommended) Louis Chan, Jason Karceski and Josef. Lakonishok, "The level and persistence of growth rates." NBER working paper, 2001

WEEK 7: INVESTMENT STRATEGY (1)

Pu Shen, "The P/E ratio and stock market performance," *Federal Reserve Bank of Kansas City Economic Review*, 2000

William Beaver and Dale Morse, "What determines P/E ratios?," *Financial Analysts Journal*, 1978

Victor Bernard, "Stock price reactions to earnings announcements." In R. Thaler, *Advances in Behavioral Finance*, 1993

*(recommended) David Dreman, *Contrarian Investment Strategies: The Next Generation,* 1998.

WEEK 8: INVESTMENT STRATEGY (2)

Werner De Bondt, *Earnings forecasts and share price reversals*, 1992

Dirk Schiereck, Werner De Bondt, and Martin Weber, "Contrarian and momentum strategies in Germany." *Financial Analysts Journal*, 1999 *(recommended) Werner De Bondt, "The psychology of underreaction and overreaction in world equity markets." In D. Keim and W. Ziemba, *Security Market Imperfections in World Equity Markets*, 2000

*(recommended) Werner De Bondt and Andreas Kappler, "False beliefs." Manuscript in preparation, 2002

*(recommended) Werner De Bondt, Alex Fung, and Kin Lam, "The speculative dynamics of world equity markets." Manuscript in preparation, 2002

WEEK 9: INVESTMENT STRATEGY (3)

Hsiu-Lang Chen and Werner De Bondt, "Style momentum within the S&P-500 index." Manuscript in preparation, 2002

Clifford Asness, "The interaction of value and momentum strategies." *Financial Analysts Journal* , 1997

Jane Ou and Stephen Penman, "Financial statement analysis and the prediction of stock returns." *Journal of Accounting and Economics*, 1989

Louis Chan, Narasimhan Jegadeesh and Josef Lakonishok, "The profitability of momentum strategies." *Financial Analysts Journal*, 1999

Louis Chan, Jason Karceski and Josef Lakonishok, "New paradigm or same old hype in equity investing?" *Financial Analysts Journal*, 2000