UPCES
Undergraduate Program in Central European Studies

Charles University
Center for Economic Research and Graduate Education

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Behavioral Finance

Taught by René Levínský, Ing., Ph.D.

Summary

For most of the second half of the 20th century, the efficient markets hypothesis was the dominant theoretical concept used to describe the behavior of individual investors and financial markets. There is, however, abundant evidence that individual behavior deviates from the outcomes predicted by traditional economic theory.

In the first part of the course, we will explore heuristics and psychological biases involved in our own decision making. In the second half of the course, we will explore the impact these psychological factors have on investors' decision-making processes and on their market behavior. We will study two key concepts of behavioral finance – limits to arbitrage and investor sentiment.

We will also discuss particular examples of market inefficiencies such as closed-end fund discounts, index inclusions and market bubbles. We will also have a chance to test our refined perspectives on investor behavior in a discussion with a fund portfolio manager who tries to profit from market inefficiencies.

Objectives

The goal of this course is to provide you with a better "radar" for psychological biases affecting our decision making, with a special focus on investment decision making. Hopefully, after this course, you will be better equipped to understand market behavior and critically analyze the potential of various investment strategies to outperform the markets.

Lecturer

Martin Burda, M.A., MBA, is Chairman of the Board of Sirius Investment Company, an investment boutique specialized in global alternative investments. Martin graduated from Charles University in Prague with masters degree in nuclear and sub-nuclear physics. He then studied for a PhD in economics at CERGE-EI but left after passing all the coursework in order to pursue a career in finance. He later obtained an EMBA from the Katz School of Business at the University of Pittsburgh. In the course of his career, Martin was as a Chief Investment Officer responsible for investment processes at ING and at Ceska sporitelna (CS - the largest Czech retail bank), later also as CEO of CS's investment company. Martin cofounded Sirius Investment Company, which is currently managing $200 million in alternative investment portfolios.

Grading

Grades are based on the following components:

1. Take-home assignments during the course 40%
2. Mid-term exam 20%
3. Final exam 40%

At the end of the term, cumulative points will be converted into grades by the following scheme:

Letter Grade	Percentage	Description
A	93-100	Outstanding work
A-	90-92	
B+	87-89	Good work
B	83-86	
B-	80-82	
C+	77-79	Acceptable Work
C	73-76	
C-	70-72	
D+	67-69	Work that is significantly below average
D	63-66	
D-	60-62	
F	0-59	Work that does not meet the minimum standards for passing the course

Academic Integrity Policy

Plagiarism and other forms of academic dishonesty are not tolerated.

UPCES/IEF Non-Discrimination/Harassment Policy

The UPCES/IEF program in Prague promotes a diverse learning environment where the dignity, worth, and differences of each individual are valued and respected. Discrimination and harassment, whether based on a person's race, gender, sexual orientation, color, religion, national origin, age, disability, or other legally protected characteristic, are repugnant and completely inconsistent with our objectives. Retaliation against individuals for raising good faith claims of harassment and/or discrimination is prohibited.

UPCES/IEF Diversity Policy

UPCES/IEF fully embraces diversity and strives to create a safe and welcoming environment for students from all backgrounds. Prague is a wonderfully diverse community and UPCES/IEF is no different. All students should feel at home while studying abroad and UPCES/IEF will do its utmost to make sure that becomes a reality. Although unique challenges may arise, we believe that students from all walks of life will encounter wonderful opportunities for enrichment as they explore a new culture while studying abroad.

Schedule of classes

The course consists of the following parts:

Part I – General principles of behaviroral economics (Week 1-4)

- Econs vs Humans
- Heuristics and biases ○ Anchoring bias ○ Availability bias
  - ○ Framing

  Monty Hall problem
- Theory and practice of self control / mental accounting
- Sunk costs
- Baskets & budgets
- Overconfidence

Part II – Are markets efficient? (Week 5-7)

- Efficient markets theory
- Prospect theory
- The endowment effect / risk aversion
- Boundaries of market efficiency ○ Close-end funds ○ Twin shares ○ Equity premium ○ Volatility ○ Index inclusions
- Limits to arbitrage ○ Leverage and margin trading ○ Costs and investment horizon

Part III – Investors' sentiment and market inefficiencies (Week 8-13)

- Investors' sentiment
- Other characteristic investor behavior ○ Limited diversification
  - Churning
  - Selling and buying decisions
- Market bubbles
- Institutional investors limits and biases
- Retail investors' sentiment
- The new normal: quantitative easing and its effects on investor behavior
  - Meme stocks ○ Is fundamental valuation dead for good? Where to seek Alpha

Part IV (optional – 1 lecture) – Career advisory for future investment managers

Guest lecture(s)

I will invite 1-2 guest speakers, mainly fund managers, where you will play the role of devil's advocates, using the knowledge obtained through this course, to challenge their Alpha-generating capability.

Recommended literature:

- Barberis, N., & Thaler, R. (2003). A survey of behavioral finance. *Handbook of the Economics of Finance*, *1*, 1053-1128.
- Kahneman, D., & Tversky, A. (1979). Prospect Theory: An Analysis of Decision under Risk. *Econometrica*, *47*(2), 263-292.
- Kahneman, D. (2011). *Thinking, fast and slow*. Macmillan.
- Pompian, M. M. (2011). *Behavioral finance and wealth management: How to build investment strategies that account for investor biases*. Wiley.
- Thaler, R. H. (2015). *Misbehaving: The making of behavioral economics.* Norton.

Literature will be discussed at the beginning of the course; further literature will be announced during the course.