Seminar in Theory of Finance[1]

Finance 6331
Fall 2014
CBA 307, Wed 1:30 - 4:20
Office hours: by appointment

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Course Goal: This course is a doctoral-level introduction to Financial Economics. We will concentrate on the fundamentals of financial economics, market efficiency, corporate finance, and asset pricing. Both the theory and empirical evidence in the aforementioned topics will be studied.

Course Philosophy: The study of finance, as a stand alone field, is entering the sixth decade. Finance began as a sub-field of economics during the 1950's. Much of the seminal theoretical development and initial empirical testing occurred over the subsequent thirty years. During the most recent two decades, the finance literature has expanded significantly. As a result, it becomes more difficult to provide students with a solid foundation in the seminal work done during the infancy of the profession, while also focusing on the cutting edge research.

In order to allow the subsequent seminars in finance to focus on the more recent works (i.e. most recent 2 decades), we will spend the first half of this course studying the foundational theories and seminal works from the first thirty years of the finance literature (roughly speaking). The second half of the class will provide you with a foundation in the sub-field of Asset Pricing. Much of the work done in developing the theories in this area was also done during the first several decades of the profession. We will begin this section with a study of utility theory and continue through more recent developments of the CAPM and APT.

Format: The course will be a combination of lecture, discussion, and paper presentations. I expect that each of you will arrive at class having thoroughly read all the assigned readings and be prepared to critically discuss the issues contained therein. I will assign papers on the attached reading list to each student to present during the class period. Each presenter will provide the class with a one to two page (single spaced) review of the assigned paper(s) and present the work. The audience will be required to discuss and query the presenters with intriguing and thought-provoking questions (depending upon the quality of the discussion, audience members may be required to submit a one-page summary of each paper). In other words, the basic premise is that we will simulate an academic research seminar with a researcher presenting his/her own work to an audience of fellow researchers. The goal is to improve the research, in our case an additional goal is to learn how to present a piece of research to your peers, construct an interesting and valid research study, explore various econometric techniques, write a paper and get that paper published in a well respected journal.

Weekly Paper Summaries: I have assigned a series of papers related to the topic of discussion for that week. I expect that you will read every paper on the reading list. Each of you will produce a one page (single spaced) summary of the assigned papers. These summaries will be shared with your cohort and form a resource that I hope will help you to prepare for the midterm exam and eventually for the comprehensive exam. If through our classroom interaction, it appears that you have only read the paper you were assigned to summarize, I reserve the right to require that each of you write independent summaries of ALL the assigned papers.

Resources:

[1] I reserve the right to make changes to the syllabus as necessary.

- Assigned papers noted below.
- “Financial Theory and Corporate Policy” by Thomas E. Copeland, J. Fred Weston, and Kuldeep Shastri, Pearson Addison Wesley, 2005 **(REQUIRED)**.
- “Foundations for Financial Economics” by Chi_fu Huang and Robert H. Litzenberger, North_Holland, New York, 1988 (Strongly suggested).
- “Fundamental Methods of Mathematical Economics” by Alpha C. Chiang, 1984 (Recommended for review prior to semester, particularly Sections 1, 2, and 3).
- Additional Resources:
  - Wall Street Journal ~ believe it or not, this is a great resource for research ideas
  - “A Guide to Econometrics,” by Peter Kennedy, The MIT Press, 5th edition. ~ no disrespect to Prof Kennedy, however, this could be titled “The Idiots Guide to Econometrics.” It’s a MUST have for your bookshelf. **It will also help as you attempt to understand the methods used in many of the papers we will be reading during the semester.**

Grading: I expect all students to perform at a level commensurate with doctoral studies (i.e. work harder than you thought possible because this is the only time in your career when you have the luxury of time).

Weekly presentations, summaries, and discussion:	30%
Mid-term Exam:	35%
Final Exam:	35%

Syllabus, Introduction, Overview, Expectations	
Week 1	**Professional Development** *Writing papers:* Greene, R., M. O’Hara, and G. W. Schwert, “Joint Editorial: Advice for Authors.” *Career Advice:* Butler, A., and T. Falcon Crack <u>The Academic Job Market in Finance: A Rookie's Guide</u> Butler, A., and T. Falcon Crack <u>The Academic Job Market in Finance: A Rookie's Guide - 2006 Supplement</u> *Publishing:* Tips from Don Chance: http://www.bus.lsu.edu/academics/finance/faculty/dchance/Research/PublishingTips.pdf *Reviewing Papers:* Tips from Wayne Ferson: http://timsimin.net/Papers/Class/Advice/Fersonrefreport.pdf

Market Efficiency, Agency Cost, and Signaling Theory	
Week 2	Efficient Capital Markets: Theory (**CWS 10**)
	1. Copeland, Thomas E. and Daniel Friedman, "Partial Revelation of Information in Experimental Asset Markets," *Journal of Finance*, 46:1, 1991, 265-295. P1 **2. Daniel, K., D. Hirshleifer, and A. Subrahmanian, "Investor psychology and security market under- and over-reactions," *Journal of Finance*, 1998, 1839-1885. P2** **3. Fama, E. F., 1970, "Efficient capital markets: a review of theory and empirical work," *Journal of Finance*, May 1970, 383-417. P3** **4. Finnerty, Joseph E., "Insiders and Market Efficiency," *Journal of Finance*, 31:4, 1976, 1141-1148. S1** 5. Forsythe, Robert, Thomas R. Palfrey, and Charles R. Plott, "Asset Valuation in an Experimental Market," *Econometrica*, 50:3, 1982, 537-567. **6. Grossman, S.F., and J. Stiglitz, "Information and competitive price systems," *American Economic Review*, May 1976, 246-253. S2** 7. Hirshleifer, J., and John G. Riley, "The Analytics of Uncertainty and Information_An Expository Survey," "*Journal of Economic Literature*," 17:4, 1979, 1375-1421. 8. Schwartz, Robert A., "Efficient Capital Markets: A Review of Theory and Empirical Work: Discussion," *Journal of Finance*, 25:2, 1970, 421-423. **9. Sharpe, William F., "Efficient Capital Markets: A Review of Theory and Empirical Work: Discussion," *Journal of Finance*, 25:2, 1970, 418-420. S3**
Week 3	Efficient Capital Markets: Evidence (**CWS 11**)
	1. De Bondt, Werner F. M. and Richard Thaler, "Does the Stock Market Overreact?," Journal of Finance, 40:3, 1985, 793_805. P2 **2. Fama, Eugene F., Lawrence Fisher, Michael C. Jensen, and Richard Roll, "The Adjustment of Stock Prices to New Information," International Economic Review, 10:1, 1969, 1_21. P3** **3. Ikenberry, David, Josef Lakonishok, and Theo Vermaelen, "Market underreaction to open market share repurchases," Journal of Financial Economics, 39:2, 181-208. P1** **4. Jaffe, Jeffrey F., "The Effect of Regulation Changes on Insider Trading," The Bell Journal of Economics and Management Science, 5:1, 1974, 93_121. S2** **5. Reinganum, Marc R., "The anomalous stock market behavior of small firms in January Empirical tests for tax_loss selling effects," Journal of Financial Economics, 12:1, 1983, 89-104. S3** **6. Scholes, Myron S., "The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices," Journal of Business, 45:2, 1972, 179_211. S1**
Week 4	Information Asymmetry and Agency Theory (**CWS 12**)

	1. Akerlof, George A., "The Market for "Lemons": Quality Uncertainty and the Market Mechanism," The Quarterly Journal of Economics, 84:3, 1970, 488_500. S3 **2. Brennan, Michael J., and Patricia J. Hughes, "Stock Prices and the Supply of Information," Journal of Finance, 46:5, 1991, 1665_1691. S1** 3. **Grinblatt, Mark, and Chuan Yang Hwang, "Signaling and the Pricing of New Issues," Journal of Finance, 44:2., 1989, 393_420. S2** **4. Jensen, Michael C., and William H. Meckling, "Theory of the firm: Managerial behavior, agency costs and ownership structure," Journal of Financial Economics, 3:4, 305-360. P3** 5. Leland, Hayne E., and David H. Pyle, "Informational Asymmetries, Financial Structure, and Financial Intermediation," Journal of Finance, 32:2, 1977, 371_387. **6. Myers, Stewart, and N. Majluf, "Corporate Financing and Investment Decisions When Firms Have Information Investors Do not Have," Journal of Financial Economics, 1984, v. 13, 187-221. P1** 7. Rock, Kevin, 1986, "Why new issues are underpriced," Journal of Financial Economics, 15, 187-212. **8. Spence, Michael, "Job Market Signaling," Quarterly Journal of Economics, 87:3, 1973, 355_374. P2**
Corporate Policy	
Week 5	The Role of the CFO, Performance Measurement, and Incentive Design (**CWS 13**)
	1. Jensen, Michael C., and Kevin J. Murphy, "Performance Pay and Top_Management Incentives," Journal of Political Economy, 98:2, 1990, 225_264. P1 **2. Miller, Merton H., and Myron S. Scholes, "Dividends and Taxes: Some Empirical Evidence," Journal of Political Economy, 90:6, 1982, 1118_1141. P2** **3. Murphy, Kevin J., "Corporate Performance and Managerial Remuneration: An Empirical Analysis," Journal of Accounting and Economics, 7:1, 11-42. P3** **4. Smith, Clifford W., and Jerold L. Zimmerman, "Valuing Employee Stock Option Plans Using Option Pricing Models," Journal of Accounting Research, 14:2, 1976, 357_364. S1** **5. Holmstrom, Bengt, "Moral Hazard and Observability, The Bell Journal of Economics, 10:1, 1979, 74_91. S2** **6. Lewellen, Wilbur G., and Blaine Huntsman, "Managerial Pay and Corporate Performance," American Economic Review, 60:4, 1970, 710_720. S3**
Week 6	Valuation and Tax Policy (**CWS 14**)
	1. Kaplan, Steven, "Management Buyouts: Evidence on Taxes as a Source of Value," Journal of Finance, 44:3, 1989, 611_632. P2 **2. Miller, Merton H., "Debt and Taxes," Journal of Finance, 32:2, 1977, 261_275. P3** **3. Miller, Merton H., and Franco Modigliani, "Dividend Policy, Growth, and the Valuation of Shares," Journal of Business, 34:4, 1961, 411_433. P1**
Week 7	Capital Structure and the Cost of Capital: Theory and Evidence (**CWS 15**)

	1. Brennan, M. J., and E. S. Schwartz, "Corporate Income Taxes, Valuation, and the Problem of Optimal Capital Structure," The Journal of Business, 51:1, 1978, 103_114. S3 2. Chen, Andrew H., and E. Han Kim, "Theories of Corporate Debt Policy: A Synthesis," Journal of Finance, 34:2, 1979, 371_384. **3. DeAngelo, H., and Ronald Masulis, "Optimal Capital Structure under Corporate and Personal Taxation," Journal of Financial Economics, 8:1, 1980, 3-30. P3** **4. Marsh, Paul, "The Choice Between Equity and Debt: An Empirical Study," Journal of Finance, 37:1, 1982, 121_144. S1** **5. Masulis, Ronald, "The Effects of Capital Structure Change on Security Prices: A Study of Exchange Offers," Journal of Financial Economics, 1980, 139-178. S2** **6. Ross, Stephen A., "The Determination of Financial Structure: The Incentive_Signalling Approach," The Bell Journal of Economics, 8:1, 1977, 23_40. P1** **7. Warner, Jerold B., "Bankruptcy, absolute priority, and the pricing of risky debt claims," Journal of Financial Economics, 4:3, 1977, 239-276. P2**
Week 8	Capital Structure and the Cost of Capital: Theory and Evidence (**CWS 15**)
	1. Altman, Edward I., "A Further Empirical Investigation of the Bankruptcy Cost Question," Journal of Finance, 39:4, 1984, 1067_1089. P1 **2. Asquith, P., and D. Mullins, Jr., "Equity Issues and Offering Dilution," Journal of Financial Economics, 1986, 61-90. S1** **3. Booth, James, and Richard Smith, "Capital Raising, Underwriting, and Certification Hypothesis," Journal of Financial Economics, 1986, 261-281. P2** **4. Harris, Milton, and Artur Raviv, "Capital Structure and the Informational Role of Debt," Journal of Finance, 45:2, 1990, 321_349. S2** 5. Kane, Alex, Alan J. Marcus, and Robert L. McDonald, "Debt Policy and the Rate of Return Premium to Leverage," Journal of Financial and Quantitative Analysis, 20:4, 1985, 479_499. **6. Smith, Clifford, Jr., "Investment Banking and the Capital Acquisition Process," Journal of Financial Economics, 1986, 3-30. P3** **7. Smith, Clifford W., and Rene M. Stulz, "The Determinants of Firms' Hedging Policies," Journal of Financial and Quantitative Analysis, 20:4, 1985, 391_405. S3**
Week 9	Dividend Policy: Theory and Empirical Evidence (**CWS 16**)
	1. Vermaelen, T., "Common Stock Repurchases and Market Signaling: An Empirical Study," Journal of Financial Economics, 1981, 139-183. P2 **2. Poterba, James M., and Lawrence H. Summers, "New Evidence that Taxes Affect the Valuation of Dividends," Journal of Finance, 39:5, 1984, 1397_1415. S2** **3. Lewellen, Wilbur G., Kenneth L. Stanley, Ronald C. Lease, and Gary G. Schlarbaum, "Some Direct Evidence on the Dividend Clientele Phenomenon," Journal of Finance, 33:5, 1978, 1385_1399. P3** **4. Elton, Edwin, and Martin Gruber, "The Effect of Share Repurchase on the Value of the Firm," Journal of Finance, 23:1, 1968, 135_149. P1** **5. DeAngelo, Harry, and Linda DeAngelo, "Dividend Policy and Financial Distress: An Empirical Investigation of Troubled NYSE Firms," Journal of Finance, 45:5, 1990, 1415_1431. S3**
Week 10	**Midterm**

	1. Coase, R. H., "The Nature of the Firm," Economica, New Series, 4:16, 1937, 386_405. S1
Week 11	Capital Markets, Consumption, and Investment **(CWS 1)** Investment Decisions: The Certainty Case **(CWS 2)**
	1. Friedman, Milton, and L. J. Savage, "The Utility Analysis of Choices Involving Risk," The Journal of Political Economy, 56:4, 1948, 279_304. S3 **2. Friend, Irwin, and Marshall E. Blume, "The Demand for Risky Assets," The American Economic Review, 65:5, 1975, 900_922. P3** **3. Kahneman, Daniel, and Amos Tversky, "Prospect Theory: An Analysis of Decision under Risk," Econometrica, 47:2, 1979, 263_291. P1** **4. Thaler, Richard H., "The Psychology and Economics Conference Handbook: Comments on Simon, on Einhorn and Hogarth, and on Tversky and Kahneman," The Journal of Business, 59:4, 1986, S279_S284. S1** **5. Tobin, J., "Liquidity Preference as Behavior Towards Risk," The Review of Economic Studies, 25:2, 1958, 65_86. S2** **6. Tversky, Amos, and Daniel Kahneman, "Rational Choice and the Framing of Decisions," The Journal of Business, 59:4, 1986, S251_S278. P2**
Week 12	The Theory of Choice: Utility Theory Given Uncertainty **(CWS 3)**
Week 12	State Preference Theory **(CWS 4)**
Week 13	Objects of Choice: Mean-Variance Portfolio Theory **(CWS 5)**
	1. Sharpe, William F., "A Simplified Model for Portfolio Analysis," Management Science, 9:2, 1963, 277_293. P1
Week 14	Market Equilibrium: CAPM and APT **(CWS 6)**
	1. Amihud, Y., and H. Mendelson, "Asset Pricing and the Bid-Ask Spread," Journal of Financial Economics, 1986, 17, 223-250. 2. Blume, Marshall E., and Irwin Friend, "A New Look at the Capital Asset Pricing Model," Journal of Finance, 28:1, 1973, 19_33. **3. Chen, Nai_Fu, Richard Roll, and Stephen A. Ross Economic Forces and the Stock Market," Journal of Business, 59:3, 1986, 383_403. S1** **4. Fama, Eugene F., and Kenneth R. French, "Size and Book_to_Market Factors in Earnings and Returns," Journal of Finance, 50:1, 1995, 131_155. S2** **5. Lo, Andrew W., and A. Craig MacKinlay, "Data_Snooping Biases in Tests of Financial Asset Pricing Models," Review of Financial Studies, 3:3, 1990, 431_467. P2** **6. Roll, Richard, "A Critique of the Asset Pricing Theory's Tests," Journal of Financial Economics, 1977, 129-176. P3** **7. Sharpe, William F., "Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk," Journal of Finance, 19:3, 1964, 425_442. S3**
Week 15	The Term Structure of Interest Rates, Forward Contracts, and Futures **(CWS 8)** **FINAL EXAM**
NOTES: **Bold type** indicates REQUIRED readings for everyone; regular type are suggested further readings on a particular subject.	

NOTE: EVERYONE SHOULD READ ALL THE REQUIRED PAPERS AND BE PREPARED TO DISCUSS THEM IN CLASS (failure to be prepared for class will result in a severe penalty). *The table on the preceding pages identifies the person responsible the presentation and/or summary of the assigned* *paper* ***(to be e-mailed to the entire class no later than midnight on the day before the class, with a copy to me as well)***. *Students responsible for presenting a paper should e-mail a copy of the presentation (Powerpoint or pdf is fine) to the professor no later than midnight on the day before the class.*