FINA 9200: Theory of Finance
Course Syllabus
Fall 2012

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Introduction

This is the initial course in finance for the Terry College PhD program. The course is ambitious in that in addition to studying some of the seminal work in finance, the course will also survey many current issues in finance academic research. The intent is to give the students grounding in some of the classic issues in finance, but also introduce them early into the concept of what research is, and more explicitly, where it is.

Structure of the course

The course is divided into 15 weekly sections, with breaks around major holidays in the calendar. The class will usually meet at 3:30 – 6:15 on Thursdays in Sanford.

Course Materials

Lecture material that exists and specific reading material that I have will be posted on Blackboard. You should be able to get most of the articles from the UGA electronic journal locator - http://www.libs.uga.edu/ejournals/. When I have an electronic copy available, I will put some of the more difficult to find articles on Blackboard.

Class Text

1. Financial Theory and Corporate Policy, by Copeland, Weston & Shastri (CWS) 4th Edition, Pearson ISBN 0-321-12721-8.

Other useful sources

1. Asset Pricing – George Pennacchi, Pearson ISBN 978-0-321-12720-4.

2. The Theory of Corporate Finance, Jean Tirole Princeton University Press, ISBN 978-0-691-12556-5. Chapter 1 and Chapter 2 are good introductions to Corporations and Stylized facts of Corporate Financing.

3. The Econometrics of Financial Markets, Lo and McKinley, Princeton University Press.

4. The Modern Theory of Corporate Finance, Clifford W. Smith, ed.
ISBN 0-07-059109-1.0

5. Potentially useful websites:

Social science research network – ssrn – www.ssrn.com - thousands of Finance papers and more, started by two finance professors.

KenFrench's data library -
http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Wharton research data services – wrds - http://wrds.wharton.upenn.edu/
We have a class account for the Wharton research data services (wrds) website.
The username to this account is:
The password to this account is:

Grading

Your final grade is determined by your work according to these weights:

Presentations	20%
Homework/Quiz	30%
Participation	10%
Exams	40%

Communication

You can call or email me pretty much anytime. I will be having office hours Tuesday 3:30-4:30.

Stuff the University wants in this syllabus

i)Honesty Policy:

As a University of Georgia student, you have agreed to abide by the University's academic honesty policy, "A Culture of Honesty," and the Student Honor Code. All academic work must meet the standards described in "A Culture of Honesty" found at: http://www.uga.edu/honesty. Lack of knowledge of the academic honesty policy is not a reasonable explanation for a violation. Questions related to course assignments and the academic honesty policy should be directed to the instructor.

ii) Disclaimer:

The course policy is a general plan for the course; deviations announced to the class by the instructor may be necessary.

iii) Grading policy:

The final grade will be based on the total points earned on the material listed in this syllabus. All students will be ranked by points earned and the final grade will be based on that ranking.

iv) Make up examinations:

If you must miss an exam, we will make it up.

v) Pre-Requisite:

Permission of the PhD Coordinator.

Topics

Below is an outline of the topics covered in the course. You can expect this list to evolve.

Section 1 Overview of Risk and Return
Date: 8/16/2012

Professor Irvine's Guide to Personal Investing

Risk Aversion (CWS Chapter 3). Pennacchi, Chapter 1.

Cochrane, J., 2011. Presidential Address: Discount Rates, *Journal of Finance, 66(4).*

Machina, M. 1987. Choice under uncertainty: Problems solved and unsolved, *Journal of Economic Perspectives.*

Section 2 The Philosophy of Economic Science
Date: 8/23/2012

Rabin, M. and R. Thaler, 2001.Risk aversion, *Journal of Economic Perspectives,* 219-232.

Kinney, William, 1986. Empirical accounting research design for Ph.D. students, *The Accounting Review,* 61:2, 338-350.

Bloomfield, Robert, 2010. Traditional versus Behavioral Finance, Working paper, Cornell University.

Helpful information for PhD students:

Cochrane, J, 2005. Writing tips for PhD students. Working paper, University of Chicago.

There are several short other articles I posted on ELC and I hope you will find some of them helpful.

Section 3 Fundamentals
Date: 8/30/2012

Stochastic Dominance
Portfolio Theory
Mean Variance Decision Model
Other Statistical Methods

Gisiger, Nicolas, 2009. Risk-neutral probabilities explained, Working paper, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1395390

CWS Chapters 1-4.

Section 4 Fundamental Asset Pricing
Date: 9/6/2012

CAPM
CWS Chapter 5, Chapter 6

Fama, E., and K. French, 2004. The Capital Asset Pricing Model: Theory and evidence, *Journal of Economic Perspectives*,

Womack, K., 2003. Understanding Risk and Return, The CAPM and the Fama-French Three-factor Model, Tuck School of Business Case, 03-111.Available from Blackboard or http://papers.ssrn.com/sol3/papers.cfm?abstract_id=481881.

Barry, C. and S. Brown, 1984. Differential information and the small firm effect, *Journal of Financial Economics*, 13. 283-294.

Pastor L. and R. Stambaugh, 2011 Are stocks really less volatile in the long run? *Journal of Finance*.

Section 5 Corporate Methods I
Date: 09/13/2012

Smith, C., 1990. The theory of corporate finance: A historical overview, in The Modern Theory of Corporate Finance, 2nd edition, 1990, 3-24.

Tirole, J., Chapter 2 in The Theory of Corporate Finance.

Chaplinsky, Susan and Robert Hansen, 1993. Partial anticipation, the flow of information and the economic impact of corporate debt sales, *Review of Financial Studies*, 6:3, 709-732.

Presentation - Edmans, A., I. Goldstein, and W. Jiang 2012. The real effects of financial markets: The impact of prices on takeovers, *Journal of Finance* 67(3).

Presentation - Wintoki, J., J. Linck and J. Netter, 2012. Endogeneity and the dynamics of internal corporate governance, forthcoming, *Journal of Financial Economics*.

Section 6 The Fundamental Model Fails
Date: 09/20/2012

Barberis, N., and M. Huang 2008. Stocks as lotteries: The implications of probability weighting for security prices, *American Economic Review*.

Cochrane, J., Hischer, J. and J. Szilagyi, 2008. In search of distress risk, *Journal of Finance*, 63(6)

Giannetti A., and A. Viale, 2011. Ambiguity and the cross-section of stock returns, Working paper, Florida Atlantic University.

Presentation - Doukas, Kim and Pantzalis, 2006. Divergence of opinion and equity returns, *Journal of Financial and Quantitative Analysis*, 41:3, 573-606.

Presentation – Bali, T., N. Cakici and R. Whitelaw, 2009. Maxing out: Stocks as lotteries and the cross-section of expected returns, Journal of Financial Economics, 99, 427-446.

Presentation – Green, C., and B. Hwang, 2010. IPOs as Lotteries: Skewness preference and first-day returns, Working paper, Emory University

Section 7 Efficient Markets
Date: 09/27/2012

Fama, E., 1991. Efficient Capital Markets II, *Journal of Finance,* 46:5, 1575-1617.

Event Studies - Campbell, Lo and McKinley, (CLM) - Chapter 4.

Brown S. and J. Warner, 1985. Using daily stock returns: The case of event studies, *Journal of Financial Economics*, 14:1, 3-31.

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

Lo, A. and C. McKinley 1988. Stock prices do not follow a random walk: Evidence from a simple specification test, *Review of Financial Studies*, 1(1).

Presentation – Boudoukh, J., M., Richardson, J. Shen and R. Whitelaw 2006. Do asset prices reflect fundamentals? Freshly-squeezed evidence from the OJ market.*Journal of Financial Economics*, 83(2), 397-412.

Presentation – Ahern, K., 2009. Sample selection and event study estimation. *Journal of Empirical Finance*, 16.

Presentation – Barber, B., T. Odean and N. Zhu, 2009. Systematic Noise, Journal of Financial Markets, 12, 547-569.

CWS, Chapter 10, 11

Section 8 New Data and Methods
Date: 10/04/2012

Kaniel, R., S. Liu, G. Saar and S. Titman, 2011. Individual investor trading and return patterns around earnings announcements, forthcoming, *Journal of Finance*.

Taylor, Lucian A. 2012. Why are CEOs Rarely Fired? Evidence from Structural Estimation, forthcoming, *Journal of Finance*.

StockTwits presentation.

Presentation - Basu, S. and S. Markov, 2004. Loss function assumptions in rational expectations tests on financial analysts' earnings forecasts, *Journal of Accounting and Economics*, 38.

Section 9 Prices and Transactions Costs
Date: 10/11/2012

Grossman, S., and J. Stiglitz 1980. On the impossibility of informationally efficient markets, *American Economic Review*, 70:3, 393-408.

Odders-White, E. and M Ready, 2008. The probability and magnitude of information events, *Journal of Financial Economics*, 87, 227-248.

Pontiff, J., 2006. Costly arbitrage and the myth of idiosyncratic risk. *Journal of Accounting and Economics,* 42(1), 35-52.

Presentation - Hirshleifer, D., S. Lim and S. Teoh, 2009. Driven to distraction: Extraneous events and underreaction to earnings news, *Journal of Finance*, 64(5).

Presentation: - Da, Z., J. Engleberg and P. Gao. 2011. In search of attention, *Journal of Finance.*

Section 10 Midterm
Date: 10/18/2012

Section 11 Behavioral Corporate Finance
Date: 10/25/2012

Baker, M., R. Ruback and J. Wurgler, 2005. Behavioral corporate finance: A survey, Handbook of Corporate Finance, Espen Eckbo ed.

Presentation - Cain, M. and S. McKeon, 2012. CEO Personal risk taking and corporate policies, Working paper, Notre Dame.

Presentation - Shrive, S., 2012. Local investors, price discovery and market efficiency, *Journal of Financial Economics*, 104(1), 145-181.

Presentation – Cohen, L. and D. Lou, 2011. Complicated Firms, forthcoming, *Journal of Financial Economics*.

Section 12 Agency costs
Date: 11/01/2012

Zingales, L., 2000. In search of new foundations, *Journal of Finance*, 55:4, 1623-1653.

Fama, E. 1980. Agency problems and the theory of the firm, *Journal of Political Economy*, 88(2).

Tirole J., Chapter 1 in <u>The Theory of Corporate Finance</u>.

Presentation - Chen, J., M. Kacperczyk and H. Ortiz-Molina, 2011. Labor unions, operating flexibility and the cost of capital. *Journal of Financial and Quantitative Analysis,* 46(1).

Presentation - Baker, M., and J. Wurgler, 2006, Investor sentiment and stock returns, *Journal of Finance*, 61(4), 1645-1680.

CWS, Chapter 10

Section 13 Corporate Finance
Date: 11/08/2012

Graham J., and C. Harvey, 2001. The theory and practice of corporate finance: Evidence from the field, *Journal of Financial Economics*.

Frydenberg, S., 2004.Theory of capital structure – A review.

Presentation. - Bebchuk, L., and A. Cohen, 2009. What matters in corporate governance? *Review of Financial Studies*, 783-827.

CWS Chapter 15, 16

Section 14 Analysts and Brokers
Date: 11/15/2012

Womack, 1996. Do brokerage analysts' recommendations have investment value? *Journal of Finance,* 51:1, 137-157.

Loh, R., and M. Mian, 2006. Do accurate earnings forecasts facilitate superior investment recommendations? *Journal of Financial Economics*, 80, 455-483.

Goldstein, M., P. Irvine, E. Kandel and Z. Weiner, 2009. Brokerage commissions and institutional trading patterns, *Review of Financial Studies*, 22 (12).

Irvine, P., M. Lipson and A. Puckett, 2007, Tipping, *Review of Financial Studies*, 20 (3).

Presentation:- Juergens, J. and L. Lindsey, 2009. Getting out early: An analysis of market making activity, *Journal of Finance*

Presentation - Mola, S., and M. Guidolin, 2009.Affiliated mutual funds and analyst optimism, *Journal of Financial Economics*, 93:1, 108-137.

Presentation – Christophe, S., M. Ferri and J. Hsieh, 2010.Informed trading before analyst downgrades, *Journal of Financial Economics*, 95 (1).

Presentation - Khang, I. G., 2011. Labor quality variation over business cycles in the analyst labor market, working paper, University of Michigan.

Presentation – Chang, X., S. Dasgupta and G. Hilary, 2006. Analyst coverage and financing decisions, *Journal of Finance*, 61:6, 3009-3048.

Section 15 Networking
Date: 11/29/2012

Watts, Duncan, 2004. The "New" Science of networks, *Annual Review of Sociology,* 30, 243-270.

Pareek, A., 2009. Information Networks: Implications for mutual fund trading behavior and stock returns, working paper, Yale University.

Presentation – Fracassi C., 2009. Corporate Finance Policies and Social Networks, working paper, University of Texas.

Presentation – Fernando, C., A. May and W. Megginson, 2012. The value of investment banking relationships: Evidence from the collapse of Lehman Brothers, 67(1), 235-270.

Presentation - Green, Clifton and B. Hwang, 2009. Price-based return co-movement, *Journal of Financial Economics*, 93(1), 37-50.

Final Exam scheduled by the registrar

An incomplete list of Questions for Class Discussion

Doukas, Kim and Pantzalis (2006)

1. What is divergence of opinion and how does this paper measure divergence of opinion?
2. In what way is divergence of opinion different from standard deviation?
3. What is the unique Asset Pricing Factor this paper introduces? How is it constructed?

4. Why does DRF have a negative coefficient in the RLow column and a positive coefficient in the RHigh column? What does this mean? Does this result make sense?

Edmans, Goldstein and Jiang (2012)

1. What is the trigger effect?
2. What is the anticipation effect?
3. What is X-inefficiency?
4. How do these authors isolate these effects when there is only one observable price series?

Green and Hwang (2010)

1. What about the first day IPO return would suggest to these authors that this would be a good laboratory for examining skewness preference?
2. What are some of the existing explanations for the strange behavior of first day IPO returns?
3. How good is their expected skewness measure?
4. How do the authors solve the problem of not knowing the expected skewness of a never traded Initial Public Offering.
5. What is an IPO anyway? What are the key characteristics of IPOs?

Boudoukh, Richardson, Shen and Whitelaw (2007)

1. What is the significance of this particular test of FCOJ for efficient markets? Why FCOJ? What is the history of research into this contract?
2. How does the OLS model fail us here?
3. How does the threshold model solve these OLS failures?
4. How does a lack of FCOJ price reaction to fundamentals provide a strong argument for behavioral finance?

Loh and Mian (2006)

1. How do sell-side analysts differ from buy-side analysts?
2. Why do analysts' forecast earnings?
3. How do analysts' get paid?
4. What is a residual income valuation model?
5. What penalty function does the AFE calculation imply? What do you think analysts' actual forecast error penalty function might look like?

Pareek (2009)

1. To what extent do you think a 5% ownership stake, held in common, represents a network? An informed network?
2. What is the basic hypothesis here where the information network density affects momentum and reversals in stock prices?

3. What are the implications in Table 4 for research that uses geographical distance as a social network measure?
4. How does this measure relate to momentum in returns?

Barber, Odean, Zhu (2009)

1. What is systematic noise? How does it differ from idiosyncratic variation?
2. What principles underlie the empirical definition of systematic noise in this paper? Contrast the assumptions about retail investors against the results presented in Kaniel, Liu, Saar and Titman (2011)?
3. How is systematic noise related to the limits of arbitrage?

Kaniel, Liu, Saar, Titman (2011)

1. Describe the data the authors are working with. Does it have any advantages over the trade size classification used in other papers?
2. Can you note any disadvantages to this data set? What are its weaknesses?
3. These authors have already taken some heat for their conclusions, what do you think of the conclusions in the paper?
4. Why would intense *retail* investor trading prior to the earnings announcement lead to significant abnormal returns over the next three months? How does this conclusion contrast with other papers?

Goldstein, Irvine, Kandel and Weiner (2009)

1. What is the major shift in thinking about commissions that the authors are advocating? Why do you think academics were mistaken for so long about this contract?
2. Think about academics thinking the wrong way about things, especially if you have had some practitioner experience. It is not out of the question that academics can miss important facts. But, take your time and be sure, if you are mistaken it will hurt you.
3. Are there any consequences of the commission contract they advocate that the authors have not considered?

Irvine, Lipson Puckett (2007)
Juergens, Lindsey(2009)
Christophe, Ferri, Hsieh (2010)
Mola, Guidolin (2009)

1. What is Tipping? Do you think it should be illegal? Are there other countries where it is legal? Are there interesting comparisons to be made in that case?
2. How are the other papers in this area derived from Irvine's work? Where do they extend his tests? Can you think of any interesting experiments that should still be done?

Graham and Harvey (2001)

1. What is the point of asking CFO's what they are doing?

2. What are the consequences for corporate finance theory of CFO’s and CEO’s never wanting to cut their dividends?
3. What do you think financial flexibility means?

Bebchuk and Cohen (2009)

1. What is the Gompers, Ishii, Metrick measure of corporate governance?
2. Why is it flawed?
3. If it is so flawed, why do people use it so much?
4. Who is Bebchuk? Does he have a point of view?

Taylor (2012)

1. What does the author mean by a structural model?
2. How does the paper attempt to calculate the personal costs to board members of firing a CEO?

Further References

Barberis, N. and R. Thaler, 2002.A Survey of Behavioral Finance. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=327880

Merton, Robert C. 1987. A simple model of capital market equilibrium with incomplete information, *Journal of Finance*, 42:3, 483-510.

Amihud, Y., 1986. Asset pricing and the bid-ask spread, *Journal of Financial Economics,* 17:2, 223-249.

Prabhala, N., 1997. Conditional methods in event studies and an equilibrium justification for standard event study methods, *Review of Financial Studies*, 10:1, 1-38.

McGoun, E., 1995. The history of risk "measurement" *Critical Perspectives on Accounting*, 6, 511-532.

Ricciardi, V., 2008. The Psychology of Risk: The behavioral finance perspective. Handbook of Finance, Vol II, Investment Management and Financial Management, Chapter 10, Fabozzi, F. ed.

Prabhala N. and K. Li, 2007. Self-selection models in corporate finance, in Handbook of Corporate Finance, EspenEckboed.

Stulz, R. and H. Mehran, 2006.The economics of conflicts of interest in financial institutions, *Journal of Financial Economics,* 85:2, 267-296.
Smith, C., 1986. Investment banking and the capital acquisition process, *Journal of Financial Economics,* 15:1, 3-29. Also in (5).

Myers, S. and N. Majluf, 1984. Corporate financing and investment decisions when firms have information that investors do not have, *Journal of Financial Economics,* 13, 187-221.

Smith, C., 1986. Investment banking and the capital acquisition process, *Journal of Financial Economics,* 15:1, 3-29. Also in (5).

Hirshleifer, D., 2001. Investor Psychology and asset pricing, *Journal of Finance,* 56:4, 1533-1597.

Harris, M., and A. Raviv, 1991. The theory of capital structure, *Journal of Finance*, 46:1, 297-355.

Miller, M. 1988. The M-M propositions after 30 years, *Journal of Economic Perspectives*, 2, 99-120.

Demers, E. and C. Vega, 2008. Soft information in earnings announcements: News of Noise? Working paper, INSEAD.

O'Hara, M., 2003. Presidential address: Liquidity and price discovery, *Journal of Finance*, 58:4, 1335-1354.

Jensen, M., and Meckling, 1976. Theory of the firm: Managerial behavior, agency cost and capital structure, *Journal of Financial Economics*, 3, 205-360.

Bikhchandani, S, D. Hirshleifer and I. Welch, 1998. Learning from the Behavior of others: Conformity, Fads and Informational Cascades, *Journal of Economic Perspectives*, 12(3), 151-176.

Thompson, 2011. Simple formulas for standard errors that cluster both in firm and time, *Journal of Financial Economics*, 99.