

DSEF03 – Behavioral Finance

Masters of Commerce
Semester III
DSE – Elective Paper
DSEF003- Behavioral Finance

Course Type/ Course Code	Course Title	Lectures	Tutorials	Practical	Credit	Pre-requisites
DSEF03	Behavioral Finance	3	1	0	4	NIL

Objectives: This course is aimed at providing the students with an understanding of the influence of behavioral biases in various facets of finance, including investment in financial markets and corporate finance decisions. It demonstrates the idea of irrationality in an agent's behavior and exposes the students to the role of heuristics and biases in judgment under uncertainty.

Learning Outcomes: After completion of the course, learners will be able to:

- Recognise the foundational theories of rational and behavioral finance.
- Identify and discuss key behavioral biases and heuristics, and assess their influence on investor perceptions, judgments, and choices.
- Evaluate the role of behavioral factors in explaining market anomalies, bubbles, and crashes.
- Examine the impact of behavioral biases on corporate financial decisions.

Contents:

Unit I **(10 Hours)**

Expected Utility theory; Rationality of Agents; Risk Aversion, Behavioral Finance vs. Conventional Finance; Limits to Arbitrage; Prospect Theory; Cumulative Prospect Theory; Nudge Theory; Neuro Finance.

Unit II **(12 Hours)**

Availability heuristics, Representativeness heuristics, Anchoring bias, Overconfidence bias, Confirmation bias, Loss aversion, Self attribution bias, Disposition effect, Hindsight bias, Mental accounting, Recency bias, Frog-in-the-pan hypothesis.

Unit III **(10 Hours)**

Biases across asset classes, fundamental-based and risk-based anomalies; Rational and behavioral explanations of anomalies- augmenting asset pricing models with behavioral factors.; Role and measures of investor attention, herd behavior and investor sentiment.

Unit IV

(13 Hours)

Moral hazard and adverse selection; Signalling: corporate & personal finance decisions; Investor biases; Managerial biases; Biases of third parties/other agents; Behavioral biases in Mergers & Acquisitions.

Tutorial Exercise: The students shall be asked to to:

- Present case studies on the application of Nudge Theory by Financial intermediaries.
- Identify the biases viz-a-viz actions by individuals and estimate its outcome as profit or loss.
- Observe the daily movement of stock prices of any 10 firms across different sectors over the last 5 years. Analyse if the stock price movements are affected by anchoring bias. Examine how stocks behave when they approach or breach their 52-week highs and lows.
- Based on data from the last 10/15/20/25 years, check for the presence of different market anomalies in the Indian securities market/ real estate market/ commodity market. Evaluate their profitability.
- Estimate the presence of herd behavior in the Indian market. Evaluate its role during major crises faced by the economy.

Suggested Readings:

Books:

- Ackert, L. F., & Deaves, R. (2010). *Behavioral Finance: Psychology, Decision Making, and Markets*. Cengage Learning.
- Ackert, L. F., & Deaves, R. (2009). *Understanding Behavioral Finance*. South-Western Cengage Learning.
- Chandra, P. (2020). *Behavioural Finance*. McGraw Hill Education.
- Gakhar, D. V. (2018). *Behavioural Finance*. Hope India Publications.
- Malmendier, U. (2018). Behavioral corporate finance. In D. Bernheim, S. DellaVigna, & D. Laibson (Eds.), *Handbook of Behavioral Economics – Foundations and Applications* (Vol. 2, pp. 277–379)
- Montier, J. (2002). *Behavioural Finance: Insights into Irrational Minds and Markets*. Wiley Finance.
- Thaler, R. H. (2005). *Advances in Behavioral Finance* (Vol. II). Russell Sage Foundation.
- Tvede, L. (2002). *The Psychology of Finance: Understanding the Behavioural Dynamics of Markets*. Wiley.

Research Papers:

- Baker, M., & Wurgler, J. (2006). Investor sentiment and the cross-section of stock returns. *The Journal of Finance*, 61(4), 1645–1680.
- Barberis, N., Huang, M., & Santos, T. (2001). Prospect theory and asset prices. *Quarterly Journal of Economics*, 116(1), 1–53.
- Barberis, N., & Huang, M. (2008). Stocks as lotteries: The implications of probability

- weighting for security prices. *American Economic Review*, 98(5), 2066–2100.
- Barberis, N., Shleifer, A., & Vishny, R. (1998). A model of investor sentiment. *Journal of Financial Economics*, 49(3), 307–343.
 - Cai, C. W. (2019). Nudging the financial market? A review of the nudge theory. *Accounting and Finance*, 60(4), 3341–3365.
 - Chang, E. C., Cheng, J. W., & Khorana, A. (2000). An examination of herd behaviour in equity markets: An international perspective. *Journal of Banking & Finance*, 24(10), 1651–1679.
 - Da, Z., Engelberg, J., & Gao, P. (2011). In search of attention. *The Journal of Finance*, 66(4), 1461–1499.
 - Da, Z., Gurun, U. G., & Warachka, M. (2014). Frog in the pan: Continuous information and momentum. *AFA 2012 Chicago Meetings Paper*.
 - De Bondt, W. F. M., & Thaler, R. (1985). Does the stock market overreact? *The Journal of Finance*, 40(3), 793–805.
 - Frazzini, A. (2006). The disposition effect and underreaction to news. *The Journal of Finance*, 61(4), 2017–2046.
 - Hong, H., & Stein, J. C. (1999). A unified theory of underreaction, momentum trading, and overreaction in asset markets. *The Journal of Finance*, 54(6), 2143–2184.
 - Jegadeesh, N., & Titman, S. (1993). Returns to buying winners and selling losers: Implications for stock market efficiency. *The Journal of Finance*, 48(1), 65–91.
 - Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. *Econometrica*, 47(2), 263–291.
 - Kanojia, S. & Malhotra, D. (2023). Impact of Behavioural Biases on Investment Performance: A Comparative Analysis of Investors from India, USA, and UK. *Journal of Business Thought*, 14, 13-33.
 - Kanojia S, Singh, D. & Goswami, A. (2020). Impact of Herding on the Returns in the Indian Stock Market: An Empirical Study. *Review of Behavioral Finance*, 14(1), 115-129.
 - Odean, T. (1998). Are investors reluctant to realize their losses? *The Journal of Finance*, 53(5), 1775–1798.
 - Sehgal, S., Vasisht, V., & Deisting, F. (2024). Lottery factor and stock returns: Evidence from India. *Borsa Istanbul Review*, 24(3), 449–459
 - Shleifer, A., & Vishny, R. W. (1997). The limits of arbitrage. *The Journal of Finance*, 52(1), 35–55.
 - Singh, Amit Kumar, & Kumar, M. (2022). Analyzing the Relationship Between Psychological Biases and Initial Public Offerings Investment Decision-making in India. *Management and Labour Studies*, 47(4), 407-430.
 - Singh, Amit Kumar & Negi, D. (2022). Do Indian IPO flippers possess Disposition Bias?. *Finance India*, XXXVIII(1), 161-174.
 - Tversky, A., & Kahneman, D. (1992). Advances in prospect theory: Cumulative representation of uncertainty. *Journal of Risk and Uncertainty*, 5(4), 297–323.