Discipline Specific Elective Course- 8.5(DSE-8.5): Behavioural Finance

CREDIT DISTRIBUTION, ELIGIBILITY AND PRE-REQUISITES OF THE COURSE

Course title & Code	Credits	Credit distribution of the course			Eligibility criteria	Pre-requisite of the course (if any)
		Lecture	Tutorial	Practical/ Practice		
Behavioural Finance: DSE-8.5	**4**	**3**	**1**	**0**	**Pass in Class XII with Mathematics/Accountancy**	**NIL**

Behavioural Finance
BCH: DSE- 8.5

Learning Objectives:
Behavioural finance provides an interdisciplinary approach to study financial behaviour, thus offering a more realistic understanding of financial markets. The objective of this course is to provide a basic understanding of Behavioural finance and its practical relevance to study the financial markets.

Learning Outcomes: After the completion of the course, learners will be able to:
1. Analyse the limitations of traditional finance.
2. Examine the relevance of the theory of behavioural finance in studying financial markets.
3. Analyse the role of incomplete information and behavioural biases in financial decision making.
4. Analyse behavioural biases in different financial markets.
5. Gain insight into the effects of asymmetrical information on financial contracts.

Course Contents:

Unit 1: Traditional theory of finance (10 hours)
Neoclassical economics: Basic assumptions, Rational choice theory, Expected utility theory; Extension to finance: Modern portfolio theory. Informational efficiency: Efficient market hypothesis- Weak, semi-strong, strong forms. CAPM. Challenges to EMH - Theoretical and empirical.

Unit 2: Emergence of Behavioural finance (10 hours)
Anomalies to neoclassical economics and standard theory of finance; Stock market anomalies: January effect and day of the week effect. Speculative market bubbles. Global financial crisis in Behavioural perspective. Equity premium puzzle and siamese twins problem; Search for alternative paradigms- Influence of psychology and emergence of Behavioural finance.

Unit 3: Behavioural finance: Introduction (10 hours)

Behavioural finance: Meaning; Basic assumptions- Incomplete information, bounded rationality. Heuristics and biases- Prospect theory, endowment theory, inattention-bias, overconfidence, reference-point bias, herd Behaviour, familiarity bias, etc.

Unit 4: Behavioural biases and Asymmetric information (15 hours)
Behavioural biases under different market settings- Stock markets, mutual funds industry, insurance industry. Asymmetric information: Market for lemons - Adverse selection, moral hazard, monitoring and signalling. Economic characteristics of financial contracts - Risk neutrality and risk aversion.

Exercises:

The learners are required to:

1. Download daily data for any index for the last two years and perform a Run test. Analyse if the market is weak form efficient.
2. Download monthly data for any index for the last 10 years. Compute January returns and an average monthly return for the remaining 11 months. Also, check if the January return is more than the average for each year. Analyse the reason for its presence or absence.
3. Conduct a diagnostic test of at least 10 people to detect endowment bias.
   Assume that you have purchased a high-quality government bond for your portfolio. It has been providing good income for your family budget and you haven't considered changing it. But your financial advisor recommends another security of comparative risk and slightly higher returns. What will be your response?
   a. I will stick with Government bond because I am familiar with it.
   b. I will sell government bond and switch to the recommended security even if I am unfamiliar with it.

   Justify your stance in the context of endowment bias.
4. Survey at least 10 people and give them an option to choose a fund from top most performing mutual funds (for the last one year and the last three years) and other similarly sized and styled funds. For each respondent compare the performance of the mutual funds chosen viz a viz other mutual funds in the sample. Do these investors suffer from sample size neglect? Analyse.
5. Prepare a report on infamous insider information scams in the Indian stock market. Analyse the role of information asymmetry in each of them.

Suggested Readings:

- Hal Varian (2010) Intermediate microeconomics - A modern approach, 8th Ed. W.W. Norton, London, Ch. 37, Asymmetric information
- Kanheman, D. & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. Econometrica, 47(2), 263-291.
- Prassanna Chandra (2020) Behavioural finance, second edition, McGraw Hill.New Delhi.
- Ricardo N. Bebezuk (2003) Asymmetric information in financial markets - Introduction and applications. Cambridge University Press, Cambridge, UK. Chapter 1.
- Singh, R. (2019). Behavioural Finance PHI learning

Note: Suggested readings will be updated by the Department of Commerce and uploaded on Department's website.