Advanced Diploma in Finance (531) – Behavioural Corporate Finance

Prerequisites: Knowledge of Finance.	**Corequisites:** A pass or higher in Diploma in Finance or equivalence.
Aim: There is an abundance of evidence suggesting that the standard economic paradigm – rational agents in an efficient market – does not adequately describe behaviour in financial markets. In this course, candidates will survey the evidence and use psychology to guide alternative theories of financial markets with an eye towards identifying frontiers and opportunities for new research. The course will address the standard argument that arbitrage will eliminate any distortions caused by irrational investors. It also examines more closely the preferences and trading decisions of individual investors arguing that their systematic biases can aggregate into observed market inefficiencies. The course extends the analysis to corporate decision making, presenting the two themes of behavioural corporate finance: rational managers exploiting financial market inefficiencies and managerial decision-making biases. The course explores the evidence for both views in the context of capital structure, investment, dividend, and merger decisions.	
Required Materials: Recommended Learning Resources.	**Supplementary Materials:** Lecture notes and tutor extra reading recommendations.
Special Requirements: The course requires a combination of lectures, demonstrations and discussions.	
Intended Learning Outcomes:	**Assessment Criteria:**
1 Identify the psychological phenomena that cause corporate managers to commit expensive mistakes when making decisions.	1.1 Describe biases that lead managers to make faulty financial decisions about risky alternatives. 1.2 Analyse how reliance on heuristics and susceptibility to framing effects render managers vulnerability. 1.3 Identify investor biases 1.4 Describe how mispricing stemming from investor errors can cause managers to make faulty decisions that reduce firm value.
2 Identify how heuristics and framing affect the way managers and analysts value firms.	2.1 Explain why some financial executives and analysts rely on valuation heuristics instead of textbook techniques that emphasise intrinsic value. 2.2 Describe the main heuristics that financial executives and analysts use to compute value. 2.3 Identify the biases that arise in connection with the use of valuation heuristics. 2.4 Identify the biases that arise in connection with the use of traditional textbook techniques that emphasize intrinsic value.
3 Define how managers' forecasts project cash flows and their decisions about project adoption and termination.	3.1 Explain why managers who avoid discounted cash flow analysis are prone to select low-value projects over high-value projects.

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	3.2	Explain why overconfidence and excessive optimism lead managers to adopt negative net-present-value projects.
	3.3	Explain why the combination of aversion to a sure loss, regret, and confirmation bias leads managers to continue failing projects when they should terminate those projects.
	3.4	Distinguish between the remedies appropriate to agency conflicts and the remedies appropriate to behavioral biases.
4 Describe the manner in which managers, investors, and analysts perceive the relationship between risk and return.	4.1	Identify managers' perceptions about the characteristics that underlie risk and return.
	4.2	Explain why heuristics based on affect and representativeness lead managers and investors to associate higher expected returns with lower risk.
	4.3	Analyse how representativeness leads managers, investors, and market strategists to form biased judgments about the market risk premium.
	4.4	Describe conditions under which the heuristic "one discount rate fits all" destroys value.
5 Identify the psychological phenomena that obstruct market efficiency and the associated implications for managers' behavior.	5.1	Differentiate among the different definitions of market efficiency.
	5.2	Identify pricing phenomena involving reversals and price drift that lie at the heart of the market efficiency debate.
	5.3	Explain how the limits of arbitrage can interfere with market efficiency even in the presence of smart money.
	5.4	Describe the implications of the market efficiency debate for corporate financial decisions involving project selection, earnings guidance, stock splits, and new equity issues.
6 Identify the manner in which biases impact the decisions that managers make about capital structure, amount of financing, and capital budgeting.	6.1	Analyse factors that drive managers' decisions about capital structure.
	6.2	Be able to compute adjusted present value to assess how the managers of a financially constrained firm with undervalued equity should choose between repurchasing shares and undertaking new profitable projects.
	6.3	Explain why concerns about dilution and market timing lead investment policy to be sensitive to cash flows.
	6.4	Identify excessive optimism and overconfidence in the psychological profile of executives.
7 Identify the manner in which biases and framing impact the behavior of managers,	7.1	Explain why framing effects lead some investors to find cash dividends

investors, and market prices in respect to dividend policy.	attractive. 7.2 Identify conditions under which managers cater to investors' preference for cash dividends. 7.3 Describe heuristics that managers use to set the dividend policies of their firms. 7.4 Describe the manner in which managers view dividends differently from share repurchases.
8 Identify key psychological phenomena that serve to obstruct good corporate governance.	8.1 Explain how overconfidence prevents corporate boards from putting compensation systems in place that align the interests of managers and shareholders. 8.2 Explain the role of prospect theory casino effects in aligning the interests of shareholders and managers. 8.3 Describe how aversion to a sure loss can interfere with the alignment of the interests of investors and the interests of auditors engaged to monitor managers. 8.4 Analyze how, because of aversion to a sure loss and overconfidence, stock option–based compensation can exacerbate agency conflicts.
9 Describe how biases and framing adversely impact the behavior of managers/directors when they work together in groups.	9.1 Explain why group think, poor information sharing, and inadequate motivation underlie suboptimal decisions. 9.2 Assess the contribution of poor group process in the governance of firms that experienced major financial crises. 9.3 Describe the manner in which group process can amplify the risk attitudes of individual group members. 9.4 Identify de-biasing steps that corporate groups can take to improve group process.
10 Analyse how biases and framing adversely impact the behavior of managers when they make decisions about mergers and acquisitions.	10.1 Explain why excessive optimism and overconfidence lead the managers of acquiring firms to overpay, thereby experiencing the winner's curse. 10.2 Be able to use the press coverage measure and long holder measure to identify executives who are prone to engage in acquisitions. 10.3 Explain why the managers of target firms who are excessively optimistic, overconfident, and trust market prices can destroy value for their shareholders. 10.4 Identify the manner in which being in the domain of losses affects the decisions of executives and board members in respect to acquisition activity.
11 Demonstrate how psychological phenomena affect managers' use of real-option	11.1 Explain why opaque framing causes managers to refrain from using real-

techniques.	option techniques. 11.2 Explain how excessive optimism affects the investment policies of managers who use real-option techniques. 11.3 Explain how overconfidence affects the investment policies of managers who use real-option techniques. 11.4 Explain why excessive optimism and overconfidence mitigate the impact of agency conflicts associated with debt overhang and asset substitution. 11.5 Describe how real-option techniques can mitigate managers' tendencies to throw good money after bad.

Recommended Learning Resources: Behavioural Corporate Finance

Text Books	• Behavioural Finance: Insights into Irrational Minds and Markets (The Wiley Finance Series) (Hardcover) by James Montier. ISBN-10: 0470844876 • Understanding Behavioural Finance and the Psychology of Investing (Financial Management Association Survey & Synthesis) by Hersh Shefrin. ISBN-10: 0875848729
Study Manuals	BCE produced study packs
CD ROM	Power-point slides
Software	None