

EC371 Economic Analysis of Asset Prices Term Paper Titles

Details of assessment and submission deadlines are contained in the Undergraduate Economics Handbook, available from room 5B.211. Be sure to read the sections on **A Guide to Good Practice in Assessed Work** and **Making the best of your essays, term papers and projects**. You should attempt **one** of the listed titles.

1. What are the distinctive features of the ‘behavioural finance’ approach to the determination of asset prices? Explain and illustrate how the approach can be applied to **one** of the following: (a) ‘excess volatility’ of asset prices; (b) the overreaction and underreaction of stock market prices; (c) the equity premium puzzle.

[Your paper should identify the ways in which ‘behavioural finance’ differs from conventional mainstream financial theory, being careful to acknowledge that both encompass a broad range of ideas; you should then present a detailed analysis of **one** application in the context of your more general overview of behavioural finance.]

References for getting started:

- (a) Barberis, N. and R. H. Thaler “A Survey of Behavioral Finance”, chapter 1 of *Advances in Behavioral Finance*, vol. II, Princeton University Press, 2005.
- (b) Shiller, R. J. “From efficient markets to behavioral finance”, *Journal of Economic Perspectives*, vol 17(1), pp 83–104
- (c) Nofsinger, J. R. *The Psychology of Investing*, Prentice-Hall, 3rd edition, 2008.

2. Explain the role of the ‘arbitrage principle’ in financial economics and examine critically its application to equity markets in the context of **either** (a) Arbitrage Pricing Theory (APT) **or** (b) asset market efficiency (*not both*).

[Your paper should begin with a brief statement of the arbitrage principle: this covers standard textbook material but should be accompanied by your interpretation of what it means and the pitfalls in attempting to apply the arbitrage principle. The bulk of your paper should focus on either (a) or (b) as stated in the question. With regard to the APT, your paper should explain how the arbitrage principle is applied and its implications, but a derivation of the APT prediction is *not* needed. More important is to discuss how the APT prediction can be applied in practice. With regard to ‘efficiency’ your paper should explain and assess the extent to which arbitrage can provide criteria for empirical investigations of efficiency (being careful to discuss the strengths and weaknesses of the approach). .]

References for getting started:

- (a) Varian, H. R. “The Arbitrage Principle in Financial Economics” *Journal of Economic Perspectives* vol. 1, Fall 1987, pp. 55–72
- (b) Shliefer, A. and R. W. Vishny “The Limits of Arbitrage”, *Journal of Finance*, vol. 52(1), March 1997, pp. 35–55, reprinted as chapter 2 of *Advances in Behavioral Finance*, vol. II, Princeton University Press, 2005 (see also chapter 4 in the same volume).
- (c) Elton, E. J., M. J. Gruber, S. J. Brown & W. Goetzmann: *Modern Portfolio Theory and Investment Analysis*, ch. 16

3. Examine the distinguishing characteristics of ‘bubbles’ in asset prices and discuss their implications. Illustrate your analysis with reference to the financial crisis beginning in 2007. .
[While the financial crisis of 2007/09 is important for the paper, you should not simply write a descriptive narrative of events. Begin your paper with an overview of the conventional features of price bubbles, followed by a discussion of how these features make bubbles distinctive. With regard to ‘implications’ (read the question carefully) you should focus on (i) theories that have been proposed to explain bubbles, and (ii) the implications for government policy (e.g. should the central bank try to prick bubbles before they become extreme?). You should, at your discretion, integrate your discussion of the 2007/09 crises as you proceed, or reserve discussion for a substantial section towards the end of your paper.]

References for getting started:

- (a) Garber, P. “Famous First Bubbles”, *Journal of Economic Perspectives*, 1990, vol. 4, No. 2, pp. 35–54.
- (b) Shiller, J. R. *Irrational Exuberance*, Princeton University Press, second edition, 2005, especially chapters 1, 3, 4.
- (c) Acharya, V. V. and M. Richardson (eds.) *Restoring Financial Stability: How to Repair a Failed System*, 2009, “Prologue: A Bird’s-Eye View”, pp. 1–56

4. Outline the main mechanisms used for trading stocks and shares in major financial centres. Discuss the implications of the various mechanisms for how well asset markets function and hence assess the regulatory measures that are appropriate to govern the operation of such markets.

[Your paper should begin with an integrated survey of trading mechanisms, emphasising their distinctive aspects and how the mechanisms may affect the determination of asset prices. Then you should interpret ‘how well asset markets function’ in the context of market efficiency being careful to analyse various aspects of ‘efficiency’. With regard to regulation, your paper should discuss the objectives of regulation, the policies implied by the objectives and how effective the policies are likely to be.]

References for getting started:

- (a) de Jong, F. and B. Rindi *The Microstructure of Financial Markets*, Cambridge University Press, 2009, ch. 1.
- (b) Spencer, Peter D. *The Structure and Regulation of Financial Markets*, Oxford University Press, 2000, ch. 4.
- (c) O’Hara, M. *Market Microstructure Theory*, Blackwell, 1995, ch. 1.
