

University of Victoria, Econ 435, Spring 2010

Financial Economics – CRN 24824

Course Outline

Class times: MR, 11.30-12.50pm, DSB C112

Instructor: Dr. Paul Schure, BEC 336, Email: schure@uvic.ca

Office hours: Wednesdays 2–3pm, or by email appointment

Course website: <http://web.uvic.ca/~schure/econ435/econ435.html>

Description:

This course surveys the established finance models used to explain forward, future, bond, and stock equity returns. The models are organized around three pricing principles: arbitrage pricing, present-value pricing, and general-equilibrium-asset pricing. These principles are fairly abstract and the associated models are quite mathematical. We will cover a lot of material and this is a challenging course.

Econ 435 assumes a basic understanding of microeconomics and statistics at the level covered in the prerequisites ECON 313 and ECON 246 (or equivalent). Corporate finance COM 240 and money and banking ECON 305 are also prerequisites for this course. Other courses that involve finance such as COM 445, ECON 454, and MATH 242 nicely complement this course.

Textbooks:

The main textbook for this course is *Investments*, Sixth Canadian Edition, by Bodie, Kane, Marcus, Perrakis and Ryan (McGraw-Hill Ryerson, ISBN 978-0070965454). “Bodie” is the leading introductory text in the field. It is designed to be consistent with the Chartered Financial Analysts (CFA) curriculum and also covers material in the Canadian Securities Course (CSC). For the most part, we will follow the philosophy in Bodie and use asset-pricing models that assume financial markets are nearly efficient.

The supplementary textbook for this course is *A Random Walk Down Wall Street*, 9th Edition, by Malkiel. “Malkiel” is arguably the foremost popular classic on investing. It provides a historical and critical perspective on approaches to investing.

Assessment:

The course material is difficult and is best learned by working on analytical problems. Two problem assignments will be marked, but I assume you work in addition on end-of-chapter problems. Your final grade will be determined as follows:

Assignments	5% [due Feb 1 and Mar 8 --> submit in the assignment box]
Midterm 1	20% [Feb 8]
Midterm 2	20% [Mar 15]
Essay outline	5% [due Mar 19]
Essay	10% [due Apr 1]
Final examination	<u>40%</u> Date TBA (record services)
Total	100%

If you do better on the final exam than on your poorest midterm, I will shift 15% of the weight of that midterm to the final exam, in which case the final exam will carry a weight of 55%. Make-up tests will not be given.

The 3-hour final examination will cover material from the entire course. The final examination will include three sections. Section A consists of multiple choice questions, including multiple choice questions related to Malkiel (all chapters, except for Chapters 12 and 14). Section B consists of analytical problems, much like those in the midterms. Section C contains essay-type questions related to Bodie and/or Malkiel.

You will write your essay with a fellow student you select. The essay will be relatively short which necessitates a very economical use of words. Further details are given as we proceed.

OUTLINE

You are responsible for reading all of “*A Random Walk Down Wall Street*”. Lectures will generally follow readings from the textbook “*Investments*” unless otherwise noted. The following list is very tentative and changes may well be made as the course progresses. I may also re-shuffle when going down the list.

INTRODUCTION

1. **Basic Concepts** [Bodie Chapters 1-4]

- This will be mainly self-study, among other things:
- Real vs. Financial Assets; Taxes; Compound Interest; Real vs. Nominal Rates of Return; Stock Markets, and Stock Listings; Leverage, and Margin Transactions; The risk-return trade-off; plus institutional knowledge about assets and markets

2. **Pricing Principles: Overview**

- Determinism, Risk, Uncertainty and Fundamental Uncertainty
- The Law of One Price
- Portfolio adjustment vs. Arbitrage
- Arbitrage and the No-Arbitrage Condition

NO-ARBITRAGE PRICING

3. **Arbitrage Pricing of Derivative Assets** [Bodie Chapters 18-20]

- Forward Contracts and Pricing, Swaps
- Futures Contracts and Pricing
- Option Contracts [Malkiel Supplement, 387-419, and Appendix to Supplement, 420-424]

PRESENT-VALUE PRICING

4. **Fixed-Income Securities** [Bodie Chapters 13-15]

- Bond Prices, Rates of Return and Interest Rate Sensitivity
- Mortgages
- Term Structure of Interest Rates

5. **Common Stock Valuation** [Bodie Chapter 14]

- Fundamental Analysis
- Dividend Discount Models

GENERAL-EQUILIBRIUM-ASSET PRICING

6. **Market Information Efficiency** [Bodie Chapter 10]

- Strong, Semi-Strong, and Weak Forms of Information Efficiency
- Innovations in Information and Prices

7. **Risk Aversion, Portfolio Theory and CAPM** [Bodie Chapters 9 & 12]

- Risk and Risk Aversion
- Diversification and Optimal Portfolios
- The Capital Asset Pricing Model (CAPM), Extensions and Evidence

8. **Back to the Future of Arbitrage** [Bodie Chapters 9, 12 & 19, notes]

- The Arbitrage Pricing Theory (APT), Extensions and Evidence
- Option Pricing
- The Wild World of Derivatives
- The Limits to Arbitrage

MISCELLANEOUS

Policy on Inclusivity and Diversity: “The University of Victoria is committed to promoting, providing and protecting a positive, supportive and safe learning and working environment for all its members.” (UVic Calendar)

Plagiarism and Cheating: Students are expected to observe the same standards of scholarly integrity as their academic and professional counterparts. Students who are found to have engaged in unethical academic behaviour, including the practices described in the Calendar, are subject to penalty by the University. I may use plagiarism detection software and search engines to detect plagiarism in any written work.

- **Class attendance.** I expect students to attend classes, but will not normally monitor attendance nor unsubscribe students if I observe they have not been there. The exception will be the student essay presentations at which time I will expect students attend.
- **Web access.** Course notes will be available on the course web page. Extra material will be posted on the course web page as the term proceeds. I assume you check the course website and email through your UVic email address frequently. If you don't normally use your UVic email address, consider putting a forward on it to your regular email address.
- **Sending emails.** *Always* use an appropriate header that starts with “Econ435”.
- **Tests.** There are no retake exams. Bring your UVic identity card to the tests.
- **Travel plans.** There will be no special accommodation if travel or work plans conflict with the examination. Make sure to finalize your travel plans until after the examination timetable has been finalized or book flights that depart after the end of the examination period.