OBJECTIVES

This course introduces doctoral students in finance and related fields to capital markets research, both applied theoretical and empirical, in connection with corporate policies, business cycle, and economic growth. By the end of this quarter, students are expected to:

- have a comprehensive conceptual framework of capital markets research (i.e., be familiar with the classic papers, recent contributions to frontier topics, and economic questions);
- be able to analyze and evaluate new research efficiently; and
- have acquired the skills to conduct and present original capital markets research.

PREREQUISITES

To register for or audit FIN 532 you must have completed a first-year graduate course in finance theory, microeconomic theory, macroeconomic theory, and econometrics.

COMMUNICATIONS

Email is my primary mode of communication. I will use email to send assignments and administrative notices to all registered students. Please email my assistant Erin Wachowicz to get yourself on the email list. My teaching page for FIN 532 holds all lecture notes and assignments that I will have handed out to date.

GRADING AND AUDITING PRIVILEGE

The following components make up your course grade, if you are a registered student, or maintain your auditing privilege, if you are an auditing student:

- **Pre-Class Preparation**
  To make this class work, everyone has to work through every assigned reading before class. If you do not want to work hard, I do not want you in this class.
  Registered students: The first time that I discover you did not work through an assigned paper before class, I will issue you a warning. The second time, and every time thereafter,
that I discover you did not work through an assigned paper before class, I will deduct 1/3rd of a grad from your final grade.

Auditing students: The first two times that I discovered you did not work through an assigned paper before class, I will issue you a warning. The third time that I find out you did not work through an assigned paper before class, I will withdraw your auditing privilege. Note that you can lose your auditing privilege by coming unprepared to just one class!

- **Assignments (30 points)**
  At least every other week I will assign fairly lengthy homework. These exercises are to be completed *individually*, though you are encouraged to discuss with each other, and be handed in at or before the beginning of class on the day they are due. You are expected to start working on the assignment as soon as possible, since some of them could take days to complete. Under no circumstance will I accept late homework.

  The assignments are designed to help you understand the material, digest the assigned papers that I do not cover in class, and familiarize yourself with capital markets research. Many problems will require the use of computers. You must know or quickly learn a statistical programming language. I recommend that you use MATLAB or GAUSS to handle the data manipulation, and use SAS to obtain raw data from WRDS. Of course, you may be a die-hard programmer and would like to use C++, Fortran, or the more user friendly Fortran 90.

  Auditing students are exempt from the assignments.

- **Referee Reports and Discussions (30 points)**
  Every week that you are not working on an assignment, you will have to write a referee report on a paper I will distribute in class. Each referee report should be no longer than five pages, one-half spaced, and a conference discussion should be no longer than 15 slides, which can be completed within 15–20 minutes in a formal presentation. Depending on the ultimate size of the class, I may:

  - assign different papers to different students and
  - require that students present a discussion of the paper like those you see in conferences.

  The referee reports and conference discussions extend your knowledge of the literature and give you an idea of the substantive and methodological questions which current research focuses on. Perhaps more importantly, they teach you to form an opinion about whether a piece of research is outstanding or only mediocre. You will not be graded on whether your opinion agrees with mine, but rather on how you come to your conclusions and how well you back them up. It is very possible that I will change my mind after reading your report and/or listening to your discussion.

  Auditing students are required to hand in respectable referee reports and to present conference discussions, just like registered students. If you do not, I will immediately withdraw your auditing privilege.

- **Research Proposal (30 points)**
  You will have to submit an original research proposal (applied theoretical and/or empirical) by the end of the quarter. I realize that this is not your thesis, so I do not expect that you to come up with an economic explanation on an asset pricing anomaly or attack an uncharted research question — although if you do, I will be extremely proud of you. However, you are expected to write a paper that
uses a methodology/model introduced in this course, or more advanced, to answer an economic question of interest to you, or

improve on someone’s answer to an economic question by refining a methodology/model of interest to you.

This proposal should be no longer than 20 pages, one-half spaced, not including tables and figures. I am more interested in seeing your mind at work, than I am in reading a well-polished literature review. Generally, I think the more clever your idea is, the shorter the paper can be. In preparing your research proposal, you should choose a topic and bring yourself to the frontier of the existing literature. You should search the recent finance journals for related published papers and the SSRN or other sources for current working papers.

**Participation (10 points)**

I expect that you become an active participant in the class. You are expected to ask questions, raise issues, contribute your knowledge, and challenge the opinions of others, including mine. The class will be a lot more enjoyable for everyone if you do. I will make a note of who contributed after every class. Auditing students are required to participate, just like registered students. If you manage to establish a reputation for being quiet (it is not a good trait for the job market) I will withdraw your auditing privilege.

**TEXTBOOKS**

The required textbooks include:


The recommended textbooks include:

**Surveys of Financial Economics**


**Applied Econometrics**

Behavioral Finance


Applied Equilibrium Analysis of Dynamic Economies


Communication Skills

Tom Cruise said in “A Few Good Men” about matters of law: “What matters is not what I know, what matters is what I can prove”. The same applies to academia — what matters is not how much you know, what matters is how much you can persuade people that you know...

- Thyer, Bruce A., 1994, *Successful publishing in scholarly journals*, SAGE publications, Inc.
Contents

1 Capital Markets: The Big Picture 5

2 Empirical Finance 6
  2.1 Time-Series Predictability .................................................. 6
  2.2 Cross-Sectional Predictability: Beta Methods .......................... 7
  2.3 Cross-Sectional Predictability: SDF Methods .......................... 9
  2.4 Momentum Profits ............................................................. 10
  2.5 Stock Returns, Corporate Policies, and Events ........................ 11
    2.5.1 Event-Study Methodology ............................................. 11
    2.5.2 Earnings Announcement .............................................. 11
    2.5.3 Corporate Investment Policies ....................................... 11
    2.5.4 Corporate Financing Policies ........................................ 12
    2.5.5 Corporate Payout Policies ............................................ 12
    2.5.6 Corporate Compensation Policies .................................... 12
    2.5.7 Corporate Restructuring .............................................. 12
    2.5.8 Accruals, Earnings Management ..................................... 12

3 Applied Theoretical Analysis in Capital Markets 12
  3.1 Consumption-Based Asset Pricing ........................................ 12
  3.2 Investment-Based Asset Pricing ......................................... 14
    3.2.1 Aggregate Stock Market ............................................. 14
    3.2.2 The Cross-Section of Returns .................................... 14

1 Capital Markets: The Big Picture

Required


2. Cochrane, John H., 2001, Asset Pricing, Chapters 20 and 21


5. Fama, Eugene, 1976, Foundations of Finance, Chapter 5


Recommended


## 2 Empirical Finance

### 2.1 Time-Series Predictability

**Required**


**Recommended**


### 2.2 Cross-Sectional Predictability: Beta Methods

**Required**


Recommended


### 2.3 Cross-Sectional Predictability: SDF Methods

**Required**


**Recommended**


2.4 Momentum Profits

Required


Recommended


2.5 Stock Returns, Corporate Policies, and Events

2.5.1 Event-Study Methodology


2.5.2 Earnings Announcement


2.5.3 Corporate Investment Policies


2.5.4 Corporate Financing Policies


2.5.5 Corporate Payout Policies


2.5.6 Corporate Compensation Policies

1. To be continued...

2.5.7 Corporate Restructuring


2.5.8 Accruals, Earnings Management


3 Applied Theoretical Analysis in Capital Markets

3.1 Consumption-Based Asset Pricing

Remark: Students who are interested in this subject are highly recommended to take ECON 529, Dynamic Asset Pricing and Consumption, taught by Professor Fatih Guvenen at Economics
Department at University of Rochester, who will give a more thorough treatment on these topics than that given here.

**Required**


**Recommended**


### 3.2 Investment-Based Asset Pricing

#### 3.2.1 Aggregate Stock Market


#### 3.2.2 The Cross-Section of Returns


