

ECO 2503H1 L9101
Financial Economics I (MA)
Fall Term 2020

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Literature

There are many excellent finance books available, but most are either geared towards an MBA/undergrad or towards a doctoral audience – there is currently no adequate textbook on the market for the master's level. The material of the course relies on two textbooks. I also provide a list of other texts that you may find useful.

In addition to the textbooks, for some topics, I will also ask you to read the original literature. These papers are listed under the corresponding topic in the course outline.

Main reference textbooks:

1. Elton, Gruber, Brown, Goetzmann: *Modern Portfolio Theory and Investment Analysis*, 9th edition, 2014, Wiley. Abbreviated as EGBG in the outline

This is an MBA-level textbook with lots of examples and several empirical chapters. It covers the majority of topics that the course deals with, and provides a self-contained treatment of many additional subjects.

2. Cochrane: *Asset Pricing*, Revised Edition, Princeton University Press. Abbreviated as C in the outline

A comprehensive advanced text on asset pricing. We will use it in the 2nd part of the course.

Additional textbooks:

- Bodie, Kane, Marcus, Perrakis, Ryan: *Investments*, 7th Canadian Edition, McGraw-Hill. Abbreviated as BKM in the outline

This book provides several institutional details (also Canadian ones), and includes many topics in addition to the ones this course will cover. I recommend the book as a useful source for background reading if you find EGBG and/or the lecture slides too advanced. I reference the corresponding chapters in the outline.

- Thomas Copeland and Fred Weston: *Financial Theory and Corporate Policy*, Addison-Wesley. Abbreviated as CW in the outline

This is an undergraduate level textbook. It covers basics and gives some introduction to more advanced topics.

- Campbell, Lo and MacKinlay: *The Econometrics of Financial Markets*, 1998, Princeton University Press. Abbreviated as CLM in the outline

Focuses mainly on empirics; sets up theoretical concepts so that they can be empirically tested; very comprehensive. Useful source to learn about empirical methods; it should be your first reference text when tackling the empirical problem sets.

- Pennacchi, George: *Theory of Asset Pricing*, 2008, Prentice Hall. Abbreviated as P in the outline

An advanced text on asset pricing theory. Also contains useful references to improve mathematics skills required in finance applications.

Course Outline

The details of the course structure and of the topics covered will be displayed on Quercus. Below is a tentative outline.

In general, we will deal with two big questions: first, what determines economic agents' investment decisions, and second, how are financial assets priced, given agents' investment decisions. We will also discuss the role of information in portfolio choice and asset pricing.

The list of readings includes

- **reference elements**, which are listed in bold,
- *background readings*, shown in italics: a less technical review of some of the basics
- additional readings, in parentheses (): for a different treatment of the same topic, and for those who are particularly interested in delving deeper into a specific area

Lecture slides are always required.

We will cover the following topics, listing the approximate pace in weeks in square brackets. Note that because assessment times and types are different from previous, in-person editions of the course, the timing is also slightly different:

1. [Week 1] An introduction to asset pricing, net present value, internal rate of return – *BKM 4*, (CW 1-2),
 - **Welch, Ivo: Epilogue, in: *Corporate Finance*, 4th Edition, 2017.** Available online free [here](#). Alternatively, the entire 1st edition (an excellent corporate finance text book, completely free) can be downloaded [here](#) – the epilogue in this edition is on pp.1060-1068.
2. [Week 2] Investor preferences and risk – **EGBG 10-11 and 20**, *BKM 5*, (CW 4, P 1)

3. [Week 3] Bond pricing – **EGBG 21-22**, *BKM 12-14*
4. [Week 4] Mean-variance analysis and portfolio choice – **EGBG 4-9**, *BKM 6*, (P 2, CLM 5)
5. [Week 5] The Capital Asset Pricing Model and various extensions: asset pricing with exogenous risks – **EGBG 13-15**, *BKM 7*, (P 3)
6. [Weeks 6-7] Arbitrage Pricing Theory, factor asset pricing models, – **EGBG 14 and 16**, *BKM 8*, (P 3)
7. [Weeks 7-8] The law of one price, arbitrage, state prices, stochastic discount factor – **C 3-4 and 6**, (P 3)
 - (Hal Varian: [“The Arbitrage Principle in Financial Economics”](#), Journal of Economic Perspectives, 1987)
8. [Week 9] Consumption-based asset pricing, the equity premium puzzle, ICAPM, Hansen-Jagannathan bounds – **C 1-2 and 5**, *BKM 11*, (CLM 8, P 4)
9. [Week 10] Empirical evidence on security returns, efficient financial markets – **EGBG 17 and 25**, *BKM 9 and 11*, (CLM 2, 4), **the following two papers are also required:**
 - **Andrew W. Lo: “Efficient Markets Hypothesis” in L. Blume and S. Durlauf, *The New Palgrave: A Dictionary of Economics*, Second Edition, 2007. New York: Palgrave McMillan.**
 - **Fama, E.F., Litterman, R.: “An Experienced View on Markets and Investing”, *Financial Analysts Journal* (68)6, 1-5.**