

Princeton University
Woodrow Wilson School
Graduate Program
Spring Term 2004

WWS 582a
Financial Markets
Professor Swati Bhatt

Course Description

This course examines financial markets from both a theoretical and policy perspective. We will study modern portfolio theory, financial asset pricing theories such as the Capital Asset Pricing Model, the Arbitrage Pricing Theory and derivative security pricing theories. We will also examine key issues in corporate finance such as capital budgeting, capital structure and corporate governance. Implications for public policy are emphasized. While modern finance is one of the more technically demanding areas of economics, this course is intended to impart the important concepts without a high level of mathematical rigor; the case format is used extensively.

Prerequisites

Students should be familiar with basic statistical concepts and microeconomic theory (at the level of WWS 511c)

Course Requirements

Course requirements:

5 bi-weekly problem sets, answers must be typed (30% of grade).

7 Cases: Two pages of clear, concise text (double-spaced, typed and carefully proof-read) analyzing the case **and** participation in class discussion of the case (35% of grade; each case is worth 5%). The class participation grade will be based on the significance of contributions to classroom discussions; absences during these seven case discussion lectures will negatively impact the grade.

Final exam (35% of grade).

Readings

The textbook for the course is Mark Grinblatt and Sheridan Titman, "Financial Markets and Corporate Strategy", 2nd edition, McGraw-Hill: 2002. This is an excellent reference book; however, I will not cover the entire book and hence do not require you to purchase it. Several copies of this text are on reserve. I will be handing out detailed lecture notes prior to each lecture.

I will be providing electronic copies of all required articles.

Reading List

Lecture 1 and 2

Regulation, Financial Innovation and Markets; Risk and Measures of Risk; the Arbitrage Principle in Financial Markets.

Roe, Mark, “*Political and Legal Restraints on Ownership and Control of Public Companies*”,

Journal of Financial Economics, Vol 27, 1990

Thaler, Richard, “*From Homo Economicus to Homo Sapiens*”, **Journal of Economic Perspectives**, Winter 2000

Lamont, Owen and Richard Thaler, “*Anomalies: The Law of One Price in Financial Markets*”,

Journal of Economic Perspectives, Fall 2003.

Lecture 3

Net Present Value - Stock and Bond Valuation; Mathematics of Interest Rates; Term Structure

and Forward Rate Determination.

Grinblatt and Titman (hereafter GT), Chapter 2 (pages 30-50) and Chapter 9

Lecture 4, 5, 6 and 7

Portfolio Theory; Asset Pricing Models - Capital Asset Pricing Model, Linear Factor Models, Arbitrage Pricing Theory; The Efficient Markets Hypothesis.

Problem Set I due at the beginning of lecture 7

GT, chapters 4, 5 and 6

Malkiel, Burton, “*The Efficient Market Hypothesis and its Critics*”, **Journal of Economic Perspectives**, Winter 2003.

Shiller, Robert, “*From Efficient Markets Theory to Behavioral Finance*”, **Journal of Economic Perspectives**, Winter 2003.

Gilson, Ronald and Teinier Kraakman, “*The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*”, **Harvard Law School Discussion Paper #446**, November 2003.

Lecture 8 CASE

Discuss the following two cases: The State of South Carolina; Alcatel

Lecture 9 and 10

Derivatives; Hockey-stick Payoff Diagrams; Futures, No-arbitrage Pricing, Spot-Futures Parity.

GT, chapter 7

Lecture 11 and 12

Options, Arbitrage Bounds on Options' Prices, Put-Call Parity, Binomial Pricing, Risk-Neutral

Valuation, Black-Scholes Pricing Theory.

Problem Set II due at the beginning of lecture 11.

GT, chapter 8

Lecture 13 CASE

Risk Management - **Discuss the Long-Term Capital Management Case**

Lecture 14 and 15

Corporate Finance: Capital Budgeting

Problem Set III due at the beginning of lecture 15.

GT, chapters 10 and 11

Zingales, Luigi, "*In Search of New Foundations*", **Journal of Finance**, August 2000.

Bolton, P. and D. Scharfstein, "*Corporate Finance, The Theory of the Firm and Organizations*,

Journal of Economic Perspectives, Fall 1998.

Lecture 16 CASE

Discuss Arundel Partners case

Lecture 17 and 18

Capital Structure - Modigliani-Miller Theorems, Weighted Average Cost of Capital, Dividend

Policy.

GT, chapters 13, 14 and 15

Myers, Stewart, "*Capital Structure*", **Journal of Economic Perspectives**, Spring 2001.

Lecture 19 and 20

Financial Contracts, Corporate Governance, Venture Capital

Problem Set IV due at the beginning of lecture 20

GT, chapters 16 and 17

Roe, M. "*Political Preconditions for Separating Ownership from Corporate Control*",

Stanford Law Review, December 2000

Holmstrom, Bengt and Steven Kaplan, "*The State of U.S. Corporate Governance: What's Right*

and What's Wrong?", **NBER Working Paper #9613**, April 2003..

Gompers, Paul and Josh Lerner, "*The Venture Capital Revolution*", **Journal of Economic Perspectives**, Spring 2001

Lecture 21 CASE

Discuss the Vermeer case

Lecture 22 CASE

Discuss the Enron case

Lecture 23 CASE

Discuss the Score Educational Centers case

Lecture 24 CASE

Problem Set V due; discuss Harvard Management Co. case and New Profit, Inc. (governing the non-profit enterprise) case