Economics 234C

Financial Decision-Making in Firms
Spring 2008
Wednesday 10-12, 608-7 Evans

Instructor
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Syllabus

Course Overview
Economics 234C provides a theoretical and empirical introduction of the core topics in Corporate Finance, including: internal corporate investment, external corporate investment (= mergers & acquisitions); capital structure and financial contracting; bankruptcy; corporate governance.
The course differs from traditional courses (and textbooks) in Corporate Finance as follows:

(1) The course emphasizes empirical methodology in applied microeconomics, some of which has not even been applied in Corporate Finance (so far). As such, the course will link to empirical literature in labor economics, public finance, development economics and other fields of applied micro. The course will also be more empirical and methodological than the typical Corporate Finance class. Students will also have to complete a larger empirical project as part of the requirements. (See below.)

(2) Relatedly, not only methodologies but also topics from neighboring fields (e.g. labor, development, public finance) and corporate governance issues will receive more attention, for example the role of the media. We will cover a number of papers which are not part of the traditional corporate finance curriculum. As such, the course is intended to help doctoral students whose research focuses on those neighboring fields to explore links to financial economics and to benefit, for example, from data and methodology in finance. And it is also intended to introduce doctoral students in finance to methodologies and related research in those related fields.

Note: Since this is an introductory course in Corporate Finance, those connections to other fields will get less time devoted and remain more superficial than they deserve (given how the field of Corporate Finance is developing) and than I would like them to be. Luckily, the Department recently hired David Sraer as a post-doc for two years, and this year he is offering an “Advanced Corporate Finance” class, Econ 296, focusing exactly on this theme, research in Corporate Finance on research related to neighboring fields (e.g., IO, labor, macro...). I highly recommend it, in particular for students with applied interests.
We will cover research in Behavioral Corporate Finance wherever it speaks to the current topic. Behavioral Corporate Finance is a novel and growing area of research that aims at integrating insights from psychology into our understanding of financial decision-making in firms. Behavioral Corporate Finance comprises (i) research on rational managerial decision-making in light of investor sentiment, e.g. market timing of security issuances, and (ii) research on biased managerial decision-making, e.g. the role of managerial overconfidence in merger decisions.

**Course Assignments and Grading**

There will be several longer assignments, at least one of which involves data work, most likely using Compustat. (Get a login now! See instructions at wrds.wharton.upenn.edu.)

We will also have a mid-term and a final exam. They will contain theoretical and empirical questions about the material covered in class.

The grade composition will be as follows:

- 40% for theoretical & empirical assignments;
- 20% for the midterm exam;
- 40% for the final exam;

Finally, I will count class participation (including evidence of intelligently reading the required papers and discussing them) by adding or subtracting up to 10 points to the rest of the grades.

**Exams:**

- Regular exam, questions about a model, questions about regression specifications.
- **But:** very much geared towards research. I hope to use ideas / examples that either suggest research ideas or build on recent research (with follow up). Think about it as 2 hours being forced to develop research ideas.
- Exam dates: in class; midterm either **on 3/12 or on 3/19**; final **on 5/7**.

For 3rd-years and higher (who have passed field exams and are preparing for orals or beyond):

You can substitute the assignments with a paper. You should only do so if you are already working on a (serious) paper and are sure that you will be able to submit a complete paper at the end of the course. (NOTE: Even if you fall into this category, it is not clear you should choose this option. Hands-on work on problem sets is very often the start of a thesis paper …)

**Required Background**

As a general rule, you should have a solid training in econometrics at the level of 240A and 240B. For example, you should be familiar with OLS estimation, panel data models, and discrete-choice models, and you should have no uncertainty as to what fixed effects do in a regression. Although it is not a requirement for this course, I recommend taking at least one empirical course or course sequence: labor, public, development. In addition, I recommend 244 for advanced training in econometrics.

- You will be required to use STATA for the mandatory homework assignment.
- You will be required to use data from WRDS for the mandatory homework assignment.
  - WRDS = main source of finance data sets
  - Got a class account.
    - Usernames: mfe07, mfe07a, mfe07b
• Password (for all usernames): Mfe0307 [case-sensitive]
  o Alternative: Go to wrds.wharton.upenn.edu/connect when in the Haas building or while using the campus VPN when not in Haas, and you can access the web-based version of WRDS.
  o Gary Peete, Head of Reference Services, Thomas J. Long Business & Economics Library, Haas School of Business, will give an introduction to using WRDS and other data sets on 2/13 (about 1¼ to 1½ hours).

Second, the course draws on contract theory and some game theory. I expect the first-year graduate sequence in micro-theory as background.

Third, I strongly recommend taking Adam Szeidl’s Asset Pricing class (234A). While not a prerequisite, it will ease the understanding of financial markets and finance-specific techniques such as the calculation of abnormal returns. If you are planning to take Financial Economics as a field, you have to take Asset Pricing. Also, if your main interest lies in the area of micro or macro theory you should take Asset Pricing. If, instead, your interest lies in the areas of labor economics / public finance / development / political economy / behavioral economics it is less crucial.

Fourth, I extra-strongly recommend going to finance-related seminars. Nothing conveys better what is new and exciting in finance than the ongoing research. There are two options.
• First, Haas has a regular Finance Seminar, held on Thursdays, 4:10-5:40pm at Haas. You should definitely attend as many of the Haas seminars as possible if you think that your research might end up being finance related and if you want to take advantage of the finance job market. Finance has its own “lingo” and style of research (and of seminars), and it is crucial to get to know those as early as possible. Email me if you want to get on the distribution list of seminar announcements.
• Second, I organize a Seminar + “Advising Session” in Financial Economics. The main purpose of the seminar is to simply coordinate with neighboring fields (macro, theory, public, development, psych & econ, labor) and have speakers whose research combines those fields. Since much of the most exciting research in Corporate Finance these days crosses the border to other fields, I highly recommend attending to get inspiration for interesting, cutting-edge research topics. Many of the seminars will, however, simply be joint with Haas Finance. (That’s why the default meeting time is Thursday, 4-6pm. However, whenever we coordinate with other seminars at the Economics Department, the seminar will typically meet at those times.) Details are on http://emlab.berkeley.edu/users/webfac/malmendier/e235_sp08/e235.shtml “Advising Session”: for students already actively pursuing a research paper. We meet about once a week and about 4 randomly picked (or pre-determined) people report about their progress. This semester, we are a bit tight since Adam Szeidl is on leave and I am teaching 4 courses … Nevertheless, if you are interested in being kept in the loop, email me and I will add you to the email list.
ALSO PLANNED is a financial economics lunch, depending on whether a large enough crowd of students are making progress on research papers …
**Schedule of classes**

*Note:* The schedule below and the literature list are more of a “wish list.” I will adjust them as we move along in the semester (and I will keep handing out updated versions).

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<thead>
<tr>
<th>Date</th>
<th>Class</th>
<th>Topic</th>
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<tbody>
<tr>
<td>Wednesday, 1/23</td>
<td>1</td>
<td>Overview: Topics and Tool</td>
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<tr>
<td>Wednesday, 1/30</td>
<td>2</td>
<td>Internal Investment (1): Empirics; Financial Constraints</td>
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<td>Wednesday, 2/6</td>
<td>3</td>
<td>Internal Investment (2): Asymmetric Information</td>
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<td><em>HW 1 handed out</em></td>
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<td>Wednesday, 2/13</td>
<td>4</td>
<td>Introduction to WRDS (Gary Peete, Head of Reference Services, Thomas J. Long Business &amp; Economics Library, Haas School of Business)</td>
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<td><em>HW 1 due</em></td>
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<td>Wednesday, 2/20</td>
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<td>cancelled</td>
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<td>Wednesday, 2/27</td>
<td>5</td>
<td>Internal Investment (2, continued): Asymmetric Information – other empirical applications &amp; theoretical treatment of debt</td>
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<td>Internal Investment (3): Agency</td>
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<td>Wednesday, 3/5</td>
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<td>Internal Investment (4): Overconfidence</td>
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<td>External Investment (1): Stylized Facts about M&amp;A</td>
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<td><em>HW 2 handed out [or next week]</em></td>
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<td>Wednesday, 3/12</td>
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<td>External Investment (2): Corporate Control and Voting</td>
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<td>External Investment (3): Market Timing</td>
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<td>External Investment (4): Managerial Hubris</td>
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<td><em>Discussion of HW 1</em></td>
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<td><em>HW 2 due</em></td>
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<td>Wednesday, 3/19</td>
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<td>Mid-term</td>
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<td>Wednesday, 3/26</td>
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<td><em>Spring Recess</em></td>
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<td>Wednesday, 4/2</td>
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<td><em>Discussion of Midterm</em></td>
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<td>Capital Structure (I): Modigliani-Miller Theorem, Debt Overhang</td>
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<td>Capital Structure (II): Asymmetric Information and Pecking Order</td>
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<td><em>Research Sheet due</em></td>
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<td>Wednesday, 4/9</td>
<td>10</td>
<td>Finishing up Capital Structure (II): Asymmetric Information and Pecking Order</td>
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<td><em>Discussion of HW 2</em></td>
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<td>Wednesday, 4/16</td>
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<td>Capital Structure (III): Biased Managers</td>
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<td><em>HW 3 handed out</em></td>
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<td>Wednesday, 4/23</td>
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<td>Capital Structure (IV): Biased Investors [Market Timing]</td>
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<td><em>HW 3 due</em></td>
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<td>Wednesday, 4/30</td>
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<td>IPOs, SEOs, Dividends and Repurchases</td>
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<td>Financial Contracting (Costly State-Verification)</td>
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<td>Executive Compensation</td>
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<td><em>Discussion of HW 3</em></td>
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<td>Wednesday, 5/7</td>
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<td>Corporate Governance, Media</td>
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<td>“Law, Politics &amp; Finance” (Financial development &amp; growth)</td>
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<td>Course evaluation</td>
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<td>Wednesday, 5/21</td>
<td>15</td>
<td><em>Final exam</em></td>
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**Textbooks:**
- Jean Tirole, Corporate Finance.
- Hart, Firms, Contracts, and Financial Structure
Class 2 Internal Investment
A. Is investment sensitive to cash-flow?
B. Similar puzzles in other fields of economics: macro, development
C. Why is investment sensitive to cash-flow (I): Financial Constraints


Class 3 Internal Investment (II)
A. Introduction to WRDS and other finance-related data sets.
B. Why is investment sensitive to cash-flow (2): Asymmetric information

WRDS documentation class!


Class 4+5 Internal Investment (III)
A. Why is investment sensitive to cash-flow (2 continued): Asymmetric information – more on the empirics (I/collateral sensitivity) and more on the theory (modeling debt)
B. Why is investment sensitive to cash-flow (3 + 4): Agency Costs and Overconfidence


Class 6 Internal Investment (IV), External Investment (I)
A. Why is investment sensitive to cash-flow (4): CEO Overconfidence


Class 7 External Investment (II)

A. External Investment (2): Free-riding theories

B. External Investment (3): Misvaluation theories


Class 7 External Investment (III) + Capital Structure (I)

A. External Investment (3, continued): Misvaluation theories & Empirical Tests

B. External Investment (4): Overvaluation theories (overconfidence) & Empirical Tests


Class 8 Capital Structure (II)
A. Capital Structure (2): Asymmetric information  
B. Capital Structure (3): Pecking order  


**Class 9 Capital Structure (III)**  
A. Capital Structure (3): Managerial characteristics and managerial biases  


**Class 10 Capital Structure (II)**  
A. Capital Structure (4): Investor biases and market timing  


**Class 11 New Issues, Dividends, Repurchases**  
A. Stylized Facts about IPOs  
B. Introduction to Corporate Governance and Executive Compensation  


Class 12 Corporate Governance (I)


Class 13 Corporate Governance (II)

A. Executive Compensation

B. Role of the Media
* Ariely, Dan; Gneezy, Uri; Loewenstein, George; and Nina Mazar (2005). “Large Stakes and Big Mistakes,” Working Paper.

Class 14 Financial Distress
A. Empirical approaches to measuring the costs of financial distress

Material for extra Law and Finance class
A. An overview over the law & finance literature
B. “It’s politics, stupid ..”
Material for extra Theory classes