Behavioral and household finance

Instructors: Claire Célérier (Toronto Rotman) and Sébastien Pouget (TSE)

Course Description

This course focuses on the growing field of behavioral and household finance, examining how households and investors in general should (normative) and do (positive) make financial decisions and how these decisions impact their well-being. In practice, behavioral and household finance is about the mistakes households and investors make, the reasons for these mistakes, how financial institutions exploit them, and the resulting regulatory implications.

We will cover key financial decisions households face throughout their lives, such as education, retirement, consumption smoothing, mortgages, and portfolio allocation, and discuss how the academic literature explores these decisions. We will examine different methodologies, including empirical research, life-cycle models, asset pricing, and experiments. We will see how household finance is at the intersection of behavioral economics, development economics, economics of education, real estate, banking, and asset pricing.

Behavioral and household finance is critical not only because it directly affects household welfare but also because it helps explain retail demand, with important implications for asset pricing and the role of financial institutions. The growing literature on demand-based asset pricing shows that understanding retail demand can provide valuable insights into asset prices. Additionally, the study of behavioral and household finance has regulatory implications, as it influences the design of policies and financial institutions such as banks. Households also influence financial stability, and given their role as voters, their financial well-being can have broader implications for the future of democracies.

Exceptionally the first three sessions of this class will take place in the first semester, on November 26, 27 and 28 from 2:00pm to 5:00pm. This scheduling is to take advantage of Claire Célérier's visit to TSM and TSE.

Course Structure

The course is divided into three sections (in parenthesis the instructor for the class, CL stands for Claire Célérier and SP for Sébastien Pouget):

Section 1: New Opportunities and Challenges in Household Finance (CL)

We will review some of the recent key findings in household finance for the main decisions households make. We will explore the new opportunities presented by advancements in data access and computational tools, while also discussing the main challenges faced by researchers in this field.

Section 2: Recent Literature in household finance (CL)

Claire Célérier will present specific case studies from her own research, illustrating how she addressed key challenges in household finance.

Section 3: Reflections on Academic Finance Careers (CL)

This last session with Claire Célérier will be devoted to a discussion of potential topics for future research and more generally to research and careers as an academic in finance.

Section 4: Trading game and beliefs formation (SP)

This section will start with a trading game that immerses students in a financial market. Implications for financial decision making will be drawn. We will the discuss how psychology affects investors' beliefs. Several biases and heuristics will be covered including overconfidence and confirmation bias.

Section 5: Impact on the efficiency of financial markets (SP)

Whether psychological factors have an impact on financial markets ultimately depends on arbitrageurs' ability to fight against mispricings. We will show that limits to arbitrage may arise due to trading costs, fundamental risk, noise trader risk, or synchronization risk. We will discuss how limits to arbitrage may lead to predictability in financial markets and to speculative bubbles.