Economics 214A.
Financial Decisions

This course covers basic concepts and tools in modern asset pricing and portfolio management. Emphasis will be put on the testable implications of the theories introduced in the course. The course covers a broad range of topics and students are strongly advised to consult additional texts for background reading. An introduction to empirical tests of asset pricing models is provided in


Additional recommended texts include

**General asset pricing:**

**Continuous time models and derivatives pricing:**
Course Outline
Stars indicate essential readings.

I. Introduction to Fundamental Concepts in Finance.

Lecture 1: The Canonical Two Date Arrow-Debreu State Preference Model. Pareto Efficiency, Completeness of Markets


Lectures 2 and 3: Arbitrage Strategies, Martingale Measures, State Prices and Risk Neutral Pricing


Lecture 4: Concepts of Risk, Risk Aversion and Downside Risk


Journal of Economic Perspectives, 1, 121-154.


Rothschild, Michael, and Joseph Stiglitz, 1971, "Increasing Risk II: Its Economic 

**Lecture 5: Developments in Financial Risk Management and Decision Making**

Forecasts with Applications to Financial Risk Management”. International Economic 


Journal of Forecasting, Special Issue on Density Forecasting in Economics and Finance. 
(July 2000).

evaluation”. University of Cambridge manuscript.

**II. Static Asset Pricing Relations**

**Lecture 6: Mathematics of the Portfolio Frontier, Two Fund Separation**

*Campbell, John, Andrew Lo and Craig MacKinlay, 1997, The Econometrics of 
Financial Markets, chapter 5, pages 181-188.

*Huang, Chi-fu, and Robert H. Litzenberger, 1988, Foundations for Financial 
Economics, chapters 3-4.

Appendix only.

**Lecture 7: CAPM**

of Business, 45, pp 444 - 454.

*Campbell, John, Andrew Lo and Craig MacKinlay, 1997, The Econometrics of 
Lecture 8: Factor Pricing Models


Lectures 9-10: Empirical Evidence on the CAPM and the APT


Lectures 11 and 12: Inter-temporal Asset Pricing: Testable Implications


Fama, E.F. and French, K.R., 1988, "Permanent and Temporary Components of Stock


Kim, M., Charles Nelson and Richard Starz, 1991, "Mean Reversion in Stock Prices:
Evidence and Implications", Review of Economic Studies 58, 515-528.

of Economics 105 (February), 1-28.

Lo, Andrew W., 1990, "Long Term Memory in Stock Market Prices", Econometrica 59,
1279-1314.

Lo, Andrew W. and A. Craig MacKinlay, 1988, "Stock Prices Do Not Follow Random
Walks: Evidence from a Simple Specification Test", Review of Financial Studies 1, 41-
66.

McQueen, Grant, and Steven Thorley, 1991, "Are Stock Returns Predictable? A Test

Pesaran, M. Hashem, and Timmermann, Allan, 1992, "A Simple Nonparametric Test of

*Poterba, James, and Larry Summers, 1988, "Mean Reversion in Stock Returns:

**Lectures 13 and 14: Portfolio Performance Measurement**


Blake, David, Lunde Asger, and Timmermann, Allan, 1999, "The Hazards of Mutual

Blake, David, Lehmann, Bruce, and Timmermann, Allan, 1999, "Performance
Measurement Using Multi-Asset-Class Portfolio Data". Journal of Business,
Forthcoming.

Finance, 50, 679-698.

Brown, Stephen J., Goetzmann, William, Ibbotson, Roger G., and Ross, Stephen A.,
1992, "Survivorship Bias in Performance Studies". Review of Financial Studies, 5, 553-
580.


III. Options, Futures and Forwards

Lecture 15: Option Contracts, Payoffs and Investment Strategies. Pricing Bounds


**Lecture 16: The Binomial Lattice Model**


**IV. Continuous Time Finance**

**Lectures 17 and 18: Introduction to Continuous Time Diffusion and Jump Processes**


**Lecture 19: The Black-Scholes Option Pricing Model**

Lecture 20: Extensions of the BS Option Pricing Model


